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OF AUSTRALIA

Business Law Section

General Manager
Law Design Practice
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The Treasury
Langton Crescent
PARKES ACT 2600

6 June 2014

Via email: taxlawdesign@treasury.gov.au

Dear Sir/Madam

Response to exposure draft of proposed revisions to thin capitalisation and 23AJ proposed for Tax and Superannuation Laws Amendment (2014 Measures No.3) Bill 2014

- 1 The Taxation Committee of the Business Law Section of the Law Council of Australia (**the Committee**) welcomes the opportunity to comment on the exposure draft legislation released by the Government on 8 May 2014 concerning the proposed amendments to thin capitalisation and 23AJ elements to be contained in (2014 Measures No.3) Bill 2014.
- 2 The Committee provides comments to assist in the revision of the measures.
- 3 The Committee considers the Explanatory Memorandum is too brief for such complex legislation. It should include examples, presented in a manner accessible to taxpayers and their advisers, particularly relating to the worldwide gearing test and the foreign dividends rules.

Worldwide gearing debt amount – eligibility is too narrowly framed

- 4 Item 8 provides that for inward investing entities the worldwide gearing debt amount is not available in three scenarios:
 - “(c) the *worldwide gearing debt amount, unless:
 - (i) the entity has *worldwide equity of a negative amount; or
 - (ii) financial statements meeting the requirements in subsection 820-933(4) for the entity for the income year do not exist; or
 - (iii) 2 or more sets of financial statements meeting the requirements in subsection 820-933(4) for the entity for the income year exist, and the entities in relation to which each set of financial statements have been

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prepared are not identical.”
(similar exclusions appear in clause 17)

- 5 The Committee considers that the exclusion at paragraph (iii) is inappropriate tax policy. It will exclude scenarios where groups ought legitimately to benefit from the test.
- 6 We see no explanation in the draft Explanatory Memorandum to outline the objective of this exclusion. Perhaps this is intended as some form of integrity measure, to prevent taxpayers and groups inappropriately structuring multiple tiers of companies with differing financial statements so as to inappropriately benefit from the worldwide gearing debt amount rules. Perhaps it is intended to reduce the workload for the Australian Taxation Office. There is no explanation.
- 7 However the effect of the drafting is that, if an Australian company is owned by a foreign holding company which produces group financial statements, which is in turn owned by a higher tier foreign holding company which also produces group financial statements, the Australian company becomes ineligible for application of the worldwide debt amount gearing test. We suggest that this is quite inappropriate policy with inequitable outcomes for many.
- 8 The UK worldwide gearing cap approaches the issue appropriately, by providing that the worldwide debt test (WWDC) is considered by reference to the gearing calculated at the level of the ultimate parent. The Taxation (International and Other Provisions) Act 2010 provides that, inter alia:

338 Meaning of “group”

- (1) *Subject to subsections (2) and (3), in this Part “group” has the meaning for the time being given by international accounting standards.*

339 Meaning of “ultimate parent”

- 1) *For the purposes of this Part, “ultimate parent”, in relation to a group, means an entity that—*
(a) is a member of the group,
(b) is a corporate entity or a relevant non-corporate entity,
(c) is not a subsidiary (whether direct or indirect) of a corporate entity or a relevant non-corporate entity, and
(d) is not a collective investment scheme.”

345 Meaning of “UK group company” and “relevant group company”

- (1) *This section applies for the purposes of this Part.*
(2) *A company is a “UK group company” if—*
(a) it meets condition A, and
(b) it is a member of the worldwide group.
(3) *A company is a “relevant group company” if—*
(a) it meets condition A, and
(b) it meets condition B.
(4) *Condition A is ... [about residence or PE in UK]*
(5) *Condition B is that the company is either—*
(a) the ultimate parent of the worldwide group, or
(b) a relevant subsidiary of the ultimate parent of the worldwide group.
(6) *A company is a “relevant subsidiary” of the ultimate parent of the worldwide group if the company is a member of the worldwide group and—“*
(a) the company is a 75% subsidiary of the ultimate parent, ...

- 9 The UK ultimate parent rule enables proper focus of their WWDC at the highest level of the foreign company group. The rule about how the group is determined using international accounting standards allows for simplified drafting and appropriate accounting alignment.
- 10 Further, the rule the UK companies using the WWDC must be at least 75% owned by the ultimate parent means that companies are not caught by the rule inappropriately and do not benefit from the rule inappropriately if they might be group companies merely by reason of a control interest (which can arise in scenarios of minority ownership or consortium companies).
- 11 We point Treasury to this construction as being preferable to the current proposed complete denial of the worldwide gearing debt amount in such multi-tier structures.

Arms' length debt test: interaction and commencement date

- 12 The Committee notes that these changes to Australia's thin capitalisation rules are major. They are proposed to apply from 1 July 2014, and as a result of the previous announcement of the changes will have a significant impact for multinational entities in Australia, whether foreign-owned local subsidiaries (inbound entities) or entities investing overseas (outbound).
- 13 However, entities considering the restructure of their financing to comply with the proposed changes have a significant uncertainty arising from the fact that the arms' length debt test (section 820-105 of the Income Tax Assessment Act 1997) is currently under review by the Board of Taxation. While that review is focused on the administration of the test, the terms of reference to the Board include to consider which entities will be eligible for the use of the ALDT. The Board of Taxation is to report on the ALDT by December 2014, seven months hence, and there is no information currently about the potential effect of any changes that might be suggested by the Board of Taxation.
- 14 The ALDT is relevant in a range of circumstances, in situations where high quality assets can be legitimately funded, by unrelated parties, to a level higher than that allowed under the thin capitalisation safe harbours, which are to be reduced pursuant to the proposed measures.
- 15 The Committee submits that, in order for company groups and business groups subject to the thin capitalisation rules to be in a position to make appropriate decisions about potential major financial structural decisions, it would be inappropriate to have such taxpayers subject to the possibility of multiple changes operative in relation to the year of commencing 1 July 2014. To have multiple changes could expose such groups to very significant costs in restructuring their financing arrangements.
- 16 The Committee submits that Treasury and the government consider one the two following issues in relation to the interaction of these two policy proposals.

One possibility could be to defer the commencement date for the thin capitalisation measures in the Exposure Draft until 1 July 2015 or such date as the Board of Taxation ALDT recommendations are eventually actioned, so as to present one integrated revision to the thin capitalisation rules.

Alternatively, when the Bill to implement the current thin capitalisation proposals is introduced, the Government should announce that any proposals to potentially limit the application of the ALDT would not be effective until some appropriate future date, say the year end commencing 1 July 2016. This would provide groups an appropriate environment in which to restructure their financing to comply with the proposed measures.

Schedule Foreign Dividends

- 17 The draft measures in the Schedule dealing with Foreign Dividends “Repeal of s23AJ and new rules for foreign equity distributions on participation interests” follow an announcement made in the 2013-2014 Budget.
- 18 However, the measures involve the prospect of complex restructure of foreign shareholdings held by Australian companies in foreign corporations.
- 19 The measures have various relevant effects:
- (a) Allowance of non-assessable non-exempt (NANE) income status for a foreign equity distribution from a foreign company whether directly or indirectly through one or more interposed trusts or partnerships where there is a participation interest held of at least 10% in the foreign company. This is a helpful measure, which does not require restructuring of foreign interests held by Australian companies.
 - (b) A distribution received on a foreign debt instrument, which would be treated for purposes of Australia's debt-equity rules as an equity interest, will become eligible for NANE treatment if it is a foreign equity distribution (proposed section 768-5, item 4). This is a helpful measure, which does not require restructuring of foreign interests held by Australian companies.
 - (c) A distribution received on a foreign share, which is currently eligible for NANE treatment, but would not be treated for purposes of the proposed section 768-5 as a foreign equity distribution (effectively, would not be characterised under Australia's debt-equity rules as an equity interest) will no longer be eligible for NANE treatment.
- This third outcome has the potential to result in significant requirements for restructuring of some foreign shares held by some Australian companies.
- 20 The third implication above represents a significant change, for various Australian taxpayer companies which had foreign shares which might not be eligible for classification as a foreign equity distribution pursuant to the proposed section 768-5.
- 21 The Committee understands that some companies had been waiting to see the relevant legislation before contemplating restructure of their foreign shareholdings, which might require amendments to foreign constituent documents of companies and approvals from other shareholders.
- 22 Australian companies holding such shares now appear to have less than one month to restructure their foreign shares to be compliant with the proposed rules of section 768-5.
- 23 In our view this is an unrealistic lead time to adjust to the change of policy, given the potential for Australian and foreign tax implications including the application of Australian and foreign capital gains tax value shifting and myriad other rules.
- 24 The Committee therefore submits that the proposed start date of 1 July 2014 in respect of this latter impact of the proposed measures is unreasonable.
- 25 The Committee submits that the commencement date for the application of section 768-5 to foreign equity distributions received in respect of foreign shares (that is, distributions currently eligible for section 23AJ treatment) should be 1 July 2015, either at the option of the company or alternatively in all cases, in order to provide time for the companies to restructure their affairs.

- 26 In this way the changes can be introduced, but the transitional commencement mechanism would mean that companies adversely affected by the extremely short lead time arising from late introduction of the measure would not be prejudiced.

Interaction of the NANE changes with CFC rules

- 27 The Committee notes that there is a consequential change required to the Australian CFC rules which needs to be made in the draft legislation.

- 28 The current section 404 of ITAA 1936 provides a dividend exemption for controlled foreign companies, to enable cross dividends to be paid without attracting the Australian CFC rules. The section provides that

“Where the eligible CFC is a resident of a listed country or a section 404 country at the end of the eligible period, a dividend paid to it in the eligible period by a company that is a resident of a listed country or a section 404 country is notional exempt income.”

- 29 Item 6 of the draft Bill repeals section 404. The proposed section 768-5 utilises definitions and rules based Division 974. However Division 974 rules are pursuant to section 389A of ITAA 1936 excluded from application in determining the attributable income of the CFC.

The net effect of the proposed drafting is to render section 768-5 inoperative in relation to dividend treatment for CFCs.

- 30 This consequential measure requires redrafting.

If you have any questions, in the first instance please contact the Committee Chair, Mark Friezer, on (02) 9353 4129.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'John Keeves', with a long horizontal line extending to the right.

John Keeves
Chairman, Business Law Section