Law Council OF AUSTRALIA

Business Law Section

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The Treasury
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Attention: Mr Michael Atfield

Dear Mr Atfield,

Addressing Profit Shifting through the artificial loading of debt in Australia

The Taxation Committee of the Business Law Section of the Law Council of Australia (the Committee) welcomes the opportunity to provide comments and submissions in relation to the measures contained in the Proposals Paper of 14 May 2013, "Addressing Profit Shifting through the artificial loading of debt in Australia".

Outline of Submission

The primary focus of this Submission is on the proposed repeal of Section 25-90.

The Committee's submission is that the repeal of section 25-90 is inconsistent with the policy that Australia has pursued over the past decade of promoting Australia

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as a suitable jurisdiction to establish holding companies for multinational investment.

The aggressive tax planning identified in the proposals paper should be countered by specific integrity measures.

If, notwithstanding our submission, section 25-90 is to be repealed, then taxpayers with committed funding who are currently entitled to deduct interest on those funds should not be affected by the measure for so long as the funding and underlying investment in respect of which the funds were used remains in place.

The Committee is surprised that this measure was announced on Budget night without any scope for consultation about the policy intent, unlike other tax measures announced on Budget night and contained in the Proposals Paper.

Policy Background

The proposed repeal of section 25-90 is justified on the grounds that it has facilitated the use of aggressive tax planning to erode the Australian tax base significantly. However, the proposed repeal represents a significant recalibration in the policy approach underpinning Australia's outbound international rules which were set some 15 years ago by the Review of Business Taxation (the Ralph Review) and were continued through the Reform of International Taxation (RITA) process.

The Ralph Review delivered its final report "A New Tax System Redesigned" in July 1999. In his press release of 11 November 1999, Treasurer Peter Costello adopted a number of international tax recommendations of the Ralph Review - under the heading "Responding to Globalisation" he stated:

> *"Steps will be taken to ensure that Australia receives a fairer share of tax paid by multinational enterprises. In addition, measures will be introduced so that Australian businesses are not hindered from expanding overseas and that Australia becomes a more attractive investment destination.*

The Ralph Review had recommended a substantial overhaul of the thin capitalisation rules - one aspect of which was extending the rules to Australian based multinational investors. The Ralph Review recommended the repeal of the quarantining rules then in force, which restricted deductibility of interest to foreign income, together with the suggested expansion of the thin capitalisation rules. The thin capitalisation rules were to provide the mechanism for regulating interest borrowed to invest in controlled foreign entities. Section 25-90 went hand in hand with the expansion of the thin capitalisation rules to outbound investors.

In February 2003 the Board of Taxation delivered its report to the Treasurer containing its recommendations for the reform of international taxation. The then Treasurer Peter Costello released the report and outlined a legislative program which was designed to improve the competitiveness of Australian companies with offshore operations. He stated:

> "*The reforms will encourage the establishment in Australia of regional headquarters for foreign groups and improve Australia's attractiveness as a continuing base for our multinational companies."*

As a result of that announcement and various subsequent law changes we arrive at the current position where there is a regime in place which encourages Australia as a regional holding company jurisdiction. These measures include:

- conduit foreign income rules which allow Australian companies to pass income earned abroad such as dividends, royalties and interest to foreign owners without paying either Australian corporate level tax or withholding taxes;
- a participation exemption which exempts Australian companies from paying capital gains tax on sales of shares in foreign companies which conduct active business; and
- various simplifications to the CFC rules along with the repeal of the foreign investment fund (**FIF**) regime and the announced enactment of a simplified *anti roll up* or *foreign accumulation fund* (**FAF**) rule.

This package represented an explicit policy change. The outgoing international tax rules focused on ensuring that Australian resident entities paid either Australian tax or a comparable rate of tax offshore. So, for example, dividends received from comparable tax jurisdictions benefitted from tax exemption whilst those from lowly taxed jurisdictions did not - shareholder relief being limited to a credit for foreign taxes paid.

The policy settings were expressly revised in 2003 so that non-portfolio dividends from any country were exempted. The idea was that Australian owned businesses should not be subject to higher tax than their commercial competitors. There was an important proviso however - that the benefits were only available in situations where they operated active businesses. More mobile passive income, such as dividends, interest and royalties were outside the regime - being subject to tax on a current basis through the CFC and former FIF regimes.

Clearly, a critical element in pursuing this objective is the ability to deduct financing costs. There was certainly a compliance cost reduction aspect to the original recommendation which led to section 25-90, as it was acknowledged that taxpayers were using a tracing of funds approach so foreign investments were equity funded and not domestic income producing assets were to the extent possible debt funded. Nevertheless, it can be seen as a complimentary measure in the context of the overall reform of Australia's outbound taxation rules.

Attempts to position Australia as a jurisdiction from which to establish holding companies (either domestic or foreign owned) which then acquire foreign companies will be frustrated if the holding company cannot borrow to fund its acquisitions. If a taxpayer cannot borrow to finance its acquisition of foreign entities, then in many cases the presence of the abovementioned facilitative provisions such as conduit foreign income rules or the participation exemption will largely be academic.

Using debt to fund such acquisitions is to be expected: generally, debt reduces a company's average cost of capital. There is no question of tax avoidance here. Companies have been doing exactly what the government had encouraged them to do. Notwithstanding this, if repealing section 25-90 will increase the average cost of capital and make Australia less competitive on the world stage. The repeal of section 25-90 would mean that Australian based multinationals will be forced to raise equity finance, which is more expensive than debt, or else borrow in the foreign jurisdiction - where debt margins may well be higher for foreign owned borrowers.

It is not clear whether the proposed repeal of section 25-90 is linked to current discussions concerning Base Erosion Profit Shifting (BEPS). If this is the case it should be acknowledged as such - rather than justified on the grounds of being an integrity measure to counter aggressive tax schemes. And if that is the perceived motivation then it is premature given the reform of the section 23AJ rules announced in the Budget, and the Board of Taxation review of the debt-equity rules which deal with many of the relevant integrity risks.

The particular concerns of Government underlying the proposal ought be articulated and a more targeted integrity redesign of section 25-90 is the preferred approach.

If the proposal is manisfestation of a change in policy then the discussion ought be directed to what the current policy setting is before any meaningful discussion can be had about the law itself. If this is the case, the Government needs to enunciate its policy motivation clearly.

The repeal will result in a re-adoption of the tracing of funds approach

If the repeal is enacted then there will, absent any other changes, be a reversion to the previous practice where companies would simply allocate non-interest bearing funding against foreign investments. On the current state of the law this would remain possibly for new investments (although possibly more problematic for existing investments). The extent to which taxpayers will need to go to break the nexus to non-deductible use effectively is an area of great uncertainty.

This raises an obvious question - why repeal the rule at all if some companies will be able to (legitimately) arrange their affairs to secure interest deductibility?

It is understood that reorganisation of financing arrangements so as not to breach these rules is not intended to attract the application of Part IVA. However, this result is not readily apparent having regard to the terms of Part IVA. Arguably, the only motivation to restructure the debt (and possibly incur additional funding costs or break costs in order to do so) will be to avoid disallowance of what would have been deductible interest costs under section 25-90. There will generally be no clear other non-tax commercial motivation (in fact the non-tax factors will generally point to retaining the existing debt arrangement). The issue will be highlighted where the debt restructuring occurs around the time that the repeal of section 25-90 becomes effective. The inevitable consequence of this is reliance on the exercise by the Commissioner of his discretion not to apply Part IVA. This is an unsatisfactory state of affairs.

The assumption companies can restructure simply and without cost is incorrect

There have been many companies which have complied not only with the express rule set out in section 25-90, but also with the policy intent of the outbound regime as detailed above. They have borrowed funds in order that Australian companies should acquire interests in offshore companies conducting active businesses.

There seems to be some suggestion that it would be a relatively easy matter for companies to restructure their debt. However, restructuring may lead to major business costs.

For example, on occasion, funds have been borrowed on a long term basis from bank lenders or from the capital markets. In such cases there are likely to be very substantial break costs which would be required to be met if the debt is to be repaid early. Lenders, cognisant of the repeal of section 25-90, will know that borrowers seeking to restructure will be in need of the refinancing.

In such circumstances, the awareness of the need of the borrower may result in the lender looking to increase fees and costs going forward prior to agreeing to any form of restructured debt arrangement. It hardly seems fair to subject borrowers who have complied with both the letter and intent of the law to such penalties.

Any refinancing also involves significant time and cost of management, the board, legal and other advisors, a cost which may have only recently been incurred in debt arrangements locked in by taxpayers under the impression that their arrangements were completely in line with the law and clearly stated policy.

Interaction with thin capitalisation

The proposed tightening of the safe harbour rules should reduce or remove the divergence between expected levels of debt and the safe harbour debt amount.

The thin capitalisation rules should prevent the artificial loading of debt into Australian entities. It is this regime that is relevant for the restriction such behaviour. As noted, the extension of the thin capitalisation rules to outbound investors went hand in hand with the introduction of section 25-90. It is not appropriate to remove section 25-90 while retaining thin capitalisation rules as they currently stand - particularly in relation to outward investing entities.

It is not clear from a policy perspective why a deduction would be denied in relation to debt that is used in the business and is not in excess of the expected debt norms.

If Treasury has a concern about the interaction of particular debt instruments with the thin capitalisation rules (such as redeemable preference shares), on the understanding that they are treated as *associate entity debt* for thin capitalisation purposes, a more appropriate response would be to amend the thin capitalisation rules accordingly rather than repeal section 25-90.

We see no reason why the repeal of section 25-90 is required, which was implemented to achieve (and continues to achieve) clear policy objectives, to address a concern regarding artificiality in gearing. This should simply require adjustments to the rules specifically aimed at this area (Division 820).

Conclusions and Recommendations

Our specific suggestions are:

- retain section 25-90 and only amend it to have a more targeted integrity based approach to ensure that the deduction is denied where companies are engaged in aggressive tax structuring; or
- retain section 25-90 and strengthen the thin capitalisation rules (or any other integrity rules considered appropriate); or
- grandfathering the changes proposed in the discussion paper. Given that many taxpayers will have borrowed to acquire foreign investments in full compliance with explicit Government policy, it is inappropriate that any financial penalty should be suffered where that policy is subsequently reversed. The Committee therefore believes it entirely appropriate that interest on term facilities should continue to be deductible for the life of the facility;

Please do not hesitate to contact the Tax Committee Chair, Mark Friezer on (02) 9353 4227 should you have any questions.

Yours sincerely,

Frank O'Loughlin
Chairman
Business Law Section