First look at proposed thin cap and foreign dividend amendments

9 May 2014

The Federal Government has released exposure draft legislation which proposes to give effect to a number of the international tax reforms which originated in last year's Federal Budget. Specifically, this includes the proposed changes to the thin capitalisation rules and to the tax exemption for foreign dividends. The release of this material in the lead up to next week's Federal Budget is a strong confirmation of the current Government's intention to proceed with these measures and from as early as 1 July 2014.

Whilst generally the proposed law will tighten the thin capitalisation rules for most taxpayers, the proposals include a number of concessions, namely, an increase in the de minimis ‘debt deduction’ exemption (from $250,000 to $2 million per annum) and an extension of the worldwide gearing test to ‘inward investing entities’. These changes are proposed to apply to income years starting on or after 1 July 2014. As expected, there are no transitional provisions that will offer grandfathering of the existing arrangements and structures already in place.

The changes to the current ‘section 23AJ’ tax exemption for certain foreign dividends received by a company are largely integrity driven, but there is some relief for those corporate taxpayers who may have held such interests indirectly through a trust or partnership. Broadly, this change will mean that the exemption for foreign ‘dividends’ will be based solely on Australia’s debt and equity classifications, such that dividends on Redeemable Preference Shares that are classified as ‘debt’ for Australian tax purposes will no longer be exempt, and a return on non-share ‘equity’ will be exempt going forward.

Thin capitalisation reforms

The thin capitalisation regime limits deductions available for interest (and other defined debt deductions) for certain inbound and outbound investors. In simple terms, the rules operate so as to deny deductions for interest expenses and borrowing costs (debt deductions) where an entity’s actual debt exceeds the maximum level allowed by the law. There are a number of different methods for calculating the maximum debt allowed, including the ‘safe harbour debt amount’, the ‘arm’s length debt amount’ and the ‘worldwide gearing debt amount’. Different tests apply to general entities, non-bank financial entities and Authorised Deposit-taking Institutions (ADIs). The rules also distinguish between inward investors (those controlled by non-residents) and outbound investors (those with offshore investments).

Reducing the safe harbour debt amount

For a non-ADI that is not classified as a ‘financial entity’ (such entity is called a ‘general entity’), the safe harbour debt amount under the existing law is broadly calculated as 75 per cent of adjusted Australian assets. This is often referred to as a 3:1 debt to equity ratio. For a non-ADI that is classified as a financial entity, the current safe harbour debt amount is broadly calculated on a 20:1 debt to equity ratio basis. All calculations are based on averages balances of amounts that, with some specific exceptions, comply with accounting standards.

Under the proposed law change, these ratios are to be reduced to 1.5:1 for general entities (that is, 60 per cent of adjusted Australian assets) and 15:1 for financial entities.
For example under the current law, for a general entity (and ignoring any effect of using averages), an acquisition costing $400 million could be funded by $300 million of debt and $100 million of equity without triggering denial of debt deductions under the safe harbour debt amount test. Under the proposed change in the law, this acquisition would need to be funded by debt totalling no more than $24 million to ensure that there was no adverse effect under the thin capitalisation provisions.

Since many taxpayers use the safe harbour debt amount test, existing debt levels will need to be carefully reviewed before these changes to the law become operative. Given that the commencement date is 1 July 2014 for 30 June balancing taxpayers, prompt consideration will need to be taken to ensure that there are no adverse implications arising from the changes.

**Increasing the minimum capital amount for ADIs**

In the case of an ADI, there is no disallowance of debt deductions under the thin capitalisation provisions where, broadly, the ADI’s ‘average equity capital’ does not exceed the ADI’s ‘minimum capital amount’. The minimum capital amount is the lesser of the ‘safe harbour capital amount’, the ‘arm’s length capital amount’ and for an outward investing ADI, the ‘worldwide capital amount’. Under the existing law, an inward investing ADI has a safe harbour capital amount calculated as 4 per cent of its Australian risk-weighted assets. An ADI which is outward investing also has this requirement, but in addition must also have capital to fund other prescribed Australian assets.

Under the proposed law change, this percentage will increase to 6 per cent for both inward and outward investing ADIs.

**Adjusting worldwide gearing and capital ratios**

Under the existing provisions that apply to a non-ADI that is an outward investor, the entity can choose to use the worldwide gearing debt amount to determine maximum allowable debt. Generally, this method ensures that the entity is not disadvantaged (i.e. through the denial of debt deductions) where the gearing level of the Australian operations is no greater than 120 per cent of the gearing level of the entity’s worldwide group. Under the proposed law change, this percentage will be reduced to 100 per cent.

Similarly, an ADI which is an outward investor can use the worldwide capital amount test (as its minimum capital amount) provided the ADI is not also foreign controlled. Under this test, the ADI can fund its Australian investments with a minimum capital ratio equal to 80 per cent of the Tier 1 capital ratio of the its worldwide group. Under the proposed law change, this percentage is to be increased to 100 per cent.

**Allowing inward investing entities to access the worldwide gearing test**

Under the current thin capitalisation law, the worldwide gearing debt amount test is not available to inward investing entities. However, under the proposed law change, these entities will, unless the entity’s worldwide equity is negative, be able to use a worldwide gearing debt amount in determining maximum allowable debt. This will provide greater flexibility for those who may otherwise have failed to fall within the safe harbour limits as noted above (or meet the arm’s length debt amount test) as they will now have a further option to test their entitlement to debt deductions. This new test will not however apply to an ADI (consistent with the existing worldwide gearing test).

The effect of the specific worldwide gearing rule is to broadly enable an entity to gear up its Australian operations to the level of gearing of the global group. The calculation to be used will depend on whether the entity is classified as a general entity or a financial entity and also whether the entity is an inward investor (i.e. a non-resident investing into Australia) or an inward investment vehicle (i.e. a foreign controlled Australian entity).

When using this method in determining maximum allowable debt, the entity must use audited consolidated financial statements that are prepared by the foreign parent and that comply with the new requirements specified in the proposed law. These requirements include that the financial statements be prepared on a consolidated basis in accordance with the prescribed accounting standards, have an
unqualified audit report, cover an annual period that ends no later than 12 months before the start of the relevant income year, and include amounts that are relevant to the calculation namely liabilities, provisions, contingent liabilities, liabilities in respect of distributions, liabilities relating to employee benefits and net assets (or equity).

**Increasing the de minimis exemption**

Under the existing law, an entity is not subject to the thin capitalisation rules where the total of an entity’s debt deductions and those of its ‘associate entities’ do not exceed $250,000 for the year. This is commonly referred to as the ‘de minimis’ exemption. With effect from income years commencing on or after 1 July 2014, the threshold for this exemption is to be increased to $2 million of associate entity inclusive debt deductions for the year. This is a positive change that will see many entities in the small to medium category removed from the requirement to apply the thin capitalisation provisions.

**Amendments to the exemption for foreign dividends**

Currently, a dividend received by a company from a non-portfolio interest in a foreign company (i.e. an interest of ten per cent or more) is treated as ‘non-assessable non-exempt’ (NANE) income. It is not relevant that the interest, generally a legal form share, may be classified for tax purposes as a ‘debt interest’.

Under the proposed change to the law, this exemption, which is currently in section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936), will be re-written into the *Income Tax Assessment Act 1997* and will no longer apply to a dividend paid by a foreign company in respect of a debt interest. This proposed change will necessitate a review of existing arrangements including consequential impacts on related funding. This may also include a consideration of other tax rules including for example, the taxation of financial arrangement provisions and the thin capitalisation provisions.

In addition to the above change, the rewritten exemption will apply:

- to non-share dividends paid on non-share equity interests, and
- where the dividend flows through an interposed trust or partnership to a company.

However, the ability to pool portfolio and non-portfolio dividends in an offshore entity to qualify for the exemption on repatriation to Australia will be removed with the repeal of the "section 404 exemption" for dividends received by a controlled foreign company.

**A final word (for now)…**

It should also be remembered that there are a number of other possible tax changes and reviews in the pipeline that are related to the changes in this exposure draft. The Government announced late last year that it would introduce a targeted integrity rule in relation to ‘section 25-90’, which allows companies to claim deductions for interest expense incurred in relation to investment in foreign companies that generate exempt dividends. This measure is expected to take effect from 1 July 2014, however the form of this integrity rule is not yet known.

The Board of Taxation is currently undertaking a review of the thin capitalisation arm’s length debt test, with a view to making it easier to comply with and administer, and to clarify the circumstances in which the test should apply. This should help ease the impact of the reduction in the safe harbour debt amount for many taxpayers, particularly those in industries that are generally able to support higher levels of debt. Unfortunately the outcome of this review is some way off with the Board only due to report to the Government by December 2014.

The Board is also working on a review which combines a post-implementation review of the debt and equity tax rules with a review of whether there can be improved arrangements within the Australian tax system to address any inconsistencies between Australia’s and other jurisdictions’ debt and equity rules that could give rise to tax arbitrage opportunities. This review is expected to conclude in March 2015.
Treasury will be taking comments on the exposure draft legislation containing the proposed thin capitalisation and ‘section 23AJ’ amendments until Friday 6 June 2014. It is expected that following this consultation period, the final legislation will be introduced into Parliament in the upcoming Winter Sittings (commencing 13 May 2014), and hopefully, in the interest of taxpayer certainty, enacted as soon as possible.

**Let’s Talk**

For a deeper discussion of how this issue might affect your business, please contact:

Peter Collins, Melbourne  
+61 (3) 8603 6247  
peter.collins@au.pwc.com

Robert Hines, Sydney  
+61 (2) 8266 0281  
robert.hines@au.pwc.com

Chris Morris, Sydney  
+61 (2) 8266 3040  
chris.j.morris@au.pwc.com