

13 April 2023

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Dear Sir / Madam

Submission on proposed amendments to sections 25-90 and 230-15

The attached submission provides our comments on the proposed amendments to sections 25-90 and 230-15 of the Income Tax Assessment Act 1997, contained in Exposure Draft Treasury Laws Amendment (Measures for Future Bills) Bill 2013: Thin capitalisation interest limitation (**Exposure Draft**), as issued on 16 March 2023.

We will separately provide our submission on the other aspects of the Exposure Draft.

Yours faithfully



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Submission on amendments to sections 25-90 and 230-15 as proposed by the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation

Introduction

The Exposure Draft legislation for the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation includes proposed amendments that would end the deductibility of interest incurred by Australian multinationals to fund investments in foreign operations. This would occur by amending sections 25-90 and 230-15 to disallow interest expenses relating to foreign dividends that are non-assessable non-exempt income (**NANE**) under section 768-5.

These amendments, which are proposed to take effect from 1 July 2023, had not been foreshadowed in earlier Government announcements and have surprised many Australian headquartered multinationals.

Although the proposed amendments are said to be a consequence of the new earnings-based interest limitation rules, they are a fundamental reversal of long-standing policy that is not justified or required by the change from asset-based to earnings-based limits. The existing limits already exclude shareholdings in foreign subsidiaries from relevant assets and the new limits correspondingly exclude dividends from foreign subsidiaries from relevant earnings.

In our view:

- the proposed amendments are unnecessary and would significantly decrease the competitiveness of Australian headquartered multinationals relative to global peers, by increasing the effective cost of relevant debt by more than 40%;
- the proposed amendments would create a high compliance burden on Australian headquartered multinationals that employ thousands of Australians, are looking to invest for growth and already make very substantial contributions to Australia's corporate tax base; and
- the resulting detriments to Australian headquartered multinationals, that have demonstrated a strong commitment to Australian jobs and economic activity, are likely to be disproportionate to the potential revenue.

Summary of submission

The proposed amendments to sections 25-90 and 230-15 should not proceed, for the following reasons:

1. The policy underlying the existing provisions remains sound and will continue to be effective after the new earnings-based limits take effect. In particular:
 - (i) section 25-90 was always intended to operate in conjunction with the limits imposed by the outward thin capitalisation rules, which were introduced at the same time – it does not make sense to remove one while keeping the other;
 - (ii) the amendments to section 25-90 are not justified by the change from asset-based to earnings-based thin capitalisation rules, as exempt foreign dividends are excluded from tax EBITDA;

- (iii) it is ultimately futile to require tracing the use of debt, as money is fungible and over time multinationals will comply by putting in place systems to establish a deductible use (creating compliance costs that are likely to be disproportionate to the potential revenue);
 - (iv) the perceived “double benefit” of sections 25-90 and 768-5 is illusory, when considered in conjunction with the outward thin capitalisation limits, the intended operation of section 768-5 to prevent double taxation of foreign profits at the corporate level and the existing double taxation of foreign profits on distribution to Australian shareholders; and
 - (v) any requirement to prove an Australian use of debt should be limited to multinationals that choose to apply the proposed third party debt test.
2. The proposed amendments are not required by the OECD’s recommendations.
 3. The proposed amendments are inconsistent with the practice of comparable countries, which allow the equivalent of section 25-90 deductions. They would make Australia an outlier and significantly decrease the competitiveness of Australian headquartered multinationals relative to global peers.
 4. Any remaining integrity concerns should be addressed by an appropriately targeted measure, rather than the total removal of section 25-90 deductions.
 5. Transitional relief for existing debt, and guidance on how to apportion interest expense on debt that cannot practically be traced, would not resolve the above concerns. These would merely be the least harmful way to implement an inherently flawed policy.

If Treasury still wishes to consider the proposed amendments to sections 25-90 and 230-15, we respectfully suggest that Treasury should remove the proposed amendments from the thin capitalisation interest limitation bill and undertake a separate consultation process, before committing to the reversal of a policy that Australian multinationals have relied on for more than 20 years. This would allow time for proper consideration of the short-term and long-term consequences, without delaying the prompt enactment of the thin capitalisation interest limitation rules.

These submission points are discussed in further detail below. All legislative references are to the Income Tax Assessment Act 1997 (**ITAA 1997**) and Income Tax Assessment Act 1936 (**ITAA 1936**).

The Exposure Draft, if enacted in its current form, would amend both section 25-90 and subsection 230-15(3) to disallow interest expenses relating to section 768-5 NANE dividends. For simplicity, the following discussion refers only to section 25-90 but the same comments apply to subsection 230-15(3).

1. The policy underlying the existing provisions remains sound and will continue to be effective after the new earnings-based limits take effect

1.1 History and rationale for section 25-90

To understand the systemic role of section 25-90, it is necessary to understand the history of the relevant provisions, which were introduced in 2001.

Pre-2001 position

Before 2001:

- (i) dividends received by Australian companies from foreign subsidiaries were exempt income under former section 23AJ;
- (ii) interest expense relating to such income was non-deductible under section 8-1; and
- (iii) Australian headquartered multinationals were not subject to any form of thin capitalisation rule.

Under this regime, it was necessary to trace the use of borrowed funds to determine whether the relevant interest expense related to Australian operations (and was therefore deductible) or related to investments in foreign subsidiaries (and was therefore non-deductible).

New regime enacted in 2001

In 2001, the current thin capitalisation framework was introduced along with section 25-90. From that time:

- (i) dividends received by Australian companies from foreign subsidiaries continued to be exempt under former section 23AJ;
- (ii) interest expense relating to such income became deductible under section 25-90; and
- (iii) Australian headquartered multinationals became subject to new outward thin capitalisation rules, which placed an upper limit on interest deductions based on the level of debt relative to Australian assets.

These changes originated from the comprehensive review of the business tax system undertaken in 1999 by the *Review of Business Taxation (RBT)*.

The history of the changes is described in more detail in the Appendix (including extracts from the RBT's final report and relevant Explanatory Memorandum (**EM**)). The history clearly shows that in 2001 a carefully considered policy decision was taken to end the requirement for Australian headquartered multinationals to trace the use of debt and instead impose a new limit on their interest deductions via the outward thin capitalisation rules. This was implemented by enacting section 25-90 together with Subdivision 820-B (thin capitalisation rules for outward investing entities). These provisions were always intended to operate in conjunction with one another.

Proposed repeal of section 25-90 in 2013

In 2013 a proposal was made to repeal section 25-90. Based on the Treasury paper issued at the time, the proposal was motivated by integrity concerns.¹

Ultimately, after a period of extensive consultation, the proposed repeal of section 25-90 did not proceed. It was concluded that “the revenue is essentially unrealisable and it would impose unreasonable compliance costs on Australian businesses”² and “it would not be a sensible proposal to proceed on”.³

The Government at the time proceeded with other amendments to tighten the thin capitalisation rules and foreign dividend exemption, and foreshadowed a targeted anti-avoidance provision to address the integrity concerns relating to section 25-90. That measure was not subsequently pursued.

The history of these proposals and changes is described in more detail in the Appendix.

1.2 Stated rationale for amendment of section 25-90

The Exposure Draft legislation revives the 2013 proposal by effectively repealing section 25-90 (so far as it relates to section 768-5 dividends). The Exposure Draft EM now presents the following rationale for this proposal (emphasis added):

1.118 Section 768-5 of the ITAA 1997 deems certain foreign equity distributions as non-assessable non-exempt (NANE) income of an entity. At the same time, sections 25-90 and 230-15 of the ITAA 1997 provide that interest expenses incurred to derive this NANE income are deductible. This is contrary to the general rule in Australia’s tax system which provides that expenses incurred in deriving NANE income are non-deductible.

1.119 Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia. The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.

1.120 To address this double benefit and ensure the effectiveness of the thin capitalisation rules, sections 25-90 and 230-15 are amended so that they do not allow a deduction for interest expenses incurred to derive the NANE income under section 768-5.

Unfortunately, this explanation fails to acknowledge that section 25-90 was always intended to operate in conjunction with the limits imposed by the outward thin capitalisation rules (as explained when both provisions were enacted in 2001) and does not address the concerns that led to the abandonment of the earlier proposal to repeal section 25-90.

Furthermore, the explanation appears to be based on a misconception that the change from asset-based to earnings-based interest deductibility limits requires section 25-90 to be restricted, in order to maintain the “policy intent” and “ensure the effectiveness of” the interest limitation rules.

These matters are addressed in more detail below.

¹ *Addressing profit shifting through the artificial loading of debt in Australia – Proposals Paper* (14 May 2013) (2013 Treasury Paper).

² Joint media release by the Treasurer and Assistant Treasurer, 6 November 2013.

³ Mr Rob Heferen, Treasury Executive Director, Senate Estimates, 5 June 2014.

1.3 Why section 25-90 is compatible with the new interest limitation rules

The original policy intent expressed in the 1999 RBT report and 2001 EM, and accepted again in 2013, remains sound and can and should continue to operate after the interest limitation tests change from asset-based to earnings-based.

In particular, the earnings-based thin capitalisation rules would continue to impose an upper limit on the interest deductions of Australian headquartered multinationals, without the need to trace the use of money, which is inherently fungible.

The existing asset-based limits and new earnings-based limits would operate in an equivalent fashion:

- Under the existing law, shareholdings in foreign subsidiaries are excluded from the asset base. I.e. the safe harbour limit on deductible debt is 60% of Australian assets, with no requirement to trace the precise use of funds.
- Under the proposed law, dividends from foreign subsidiaries are excluded from the earnings base. I.e. the fixed ratio limit on net interest expense is 30% of Australian tax EBITDA, with no requirement to trace the precise use of funds (if section 25-90 is retained in its current form).

In either case, if debt is in fact used to invest in foreign subsidiaries, this does not increase the relevant Australian asset base or earnings base. Such activity is therefore automatically constrained by the relevant limit (i.e. is self-limiting).

This approach is consistent with the OECD's best practice recommendations (see section 2 below) and the actual practice of Australia's global peers (see section 3 below).

1.4 Why tracing is ultimately futile – behavioural responses and compliance costs

The proposed amendments to section 25-90 would reinstate the requirement to trace the use of funds, which was rightly abandoned in 2001. This is an inherently difficult task, due to the "fluidity and fungibility of money" as acknowledged in the Exposure Draft EM itself.⁴

Behavioural responses

To comply with the new requirement, multinational groups would respond by putting in place systems and processes to trace the use of new debt within their Australian operations. This would become increasingly difficult over time, as funds recycle through the business due to normal commercial arrangements such as revolving debt facilities, refinancings, reinvestment of asset sales proceeds, dividend flows, capital returns and share buybacks.

Multinational groups are also likely to apply those systems to establish a deductible use of new debt whenever possible through ordinary commercial dealings. For example, they may keep funds from customer receipts and equity raisings separate for use in foreign investments, and may choose to use debt to fund their Australian operations.

Australian headquartered multinationals are likely to be disadvantaged relative to foreign owned multinationals in this respect. The capital structure of Australian headquartered groups is set by the debt

⁴ At paragraph 1.3.

and equity they have issued to the market, while foreign-owned companies can more readily change the debt/equity mix of their Australian operations via intra-group transactions.

Consequences

Due to these behavioural responses, significant ongoing compliance costs would arise, but over time the upper limit on interest deductions in practice would tend to be set by the earnings-based fixed ratio (30% of Australian tax EBITDA), rather than the requirement to trace.

Therefore, reinstating the requirement to trace is likely to create compliance costs that are disproportionate to the potential revenue. This was the clear conclusion of the RBT in 1999, which informed the amendments made in 2001 and was endorsed again in 2013, when the previous proposal to repeal section 25-90 was abandoned (see section 1.1 above).

In contrast, retaining the thin capitalisation rules as the upper limit on the interest deductions of Australian headquartered multinationals, based on 30% of Australian tax EBITDA with no requirement to trace, would provide a test that is clear, simple to administer and consistent with the practice of Australia's global peers (see section 3).

1.5 The perceived “double benefit” of sections 25-90 and 768-5 is illusory

The Exposure Draft EM states that section 25-90 must be amended because:

... it gives rise to a “double benefit; the benefit of the [dividend] income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.

However this view is based on a false premise that it is always possible and rational to trace the use of a fungible item such as money. This is typically not the case (as discussed in section 1.4) and ignores the original intent of section 25-90 (which operates in conjunction with, and is limited by, the outbound thin capitalisation rules (see section 1.1 above)) and section 768-5.

While section 25-90 in isolation appears as an exception to the general rule that expenses incurred in deriving NANE income are non-deductible, this is a superficial view that does not reflect the operation of the relevant provisions as a whole. When considered in conjunction with the outward thin capitalisation limits, the provisions effectively operate as a statutory presumption that interest expense on fungible borrowings:

- is attributable firstly to the Australian business, up to the relevant thin capitalisation limit; and
- is otherwise attributable to the foreign business or to excessive gearing of the Australian business.

The presumption simply reflects the likely behavioural responses that would occur if section 25-90 is amended and taxpayers are required to resume tracing the use of debt (as discussed in section 1.4).

Furthermore, section 768-5 is not a true tax exemption as such, but is simply a means of preventing double taxation of foreign profits earned by Australian companies. The practical effect is similar to what would occur if foreign dividends were treated as assessable with a credit for underlying tax.⁵

⁵ See page 12 of the EM for the *Taxation Laws Amendment (Foreign Income) Bill 1990*, which introduced section 23AJ (predecessor to section 768-5) and paragraph 3.48 of the EM for the *Taxation Laws Amendment Bill (No. 4) 2003*. The latter notes that one of the reasons for treating an amount as NANE income is that “the amount is otherwise subject to income tax, or a substitute for income tax, so any further tax effect would effectively be double taxation.”

The perceived “double benefit” could only arise if NANE dividends were included in tax EBITDA (thereby inflating the earnings base), but this is not the case under the Exposure Draft legislation. Indeed, this is very reason why the OECD recommends the exclusion of tax exempt dividends from the earnings base and does not require an additional rule to deal with interest expense that may relate to such income (see section 2 below).

Wider systemic effects

For Australian headquartered multinationals, the following wider systemic effects must also be considered:

- (i) the underlying foreign profits giving rise to NANE dividends have typically been subject to foreign tax already;
- (ii) the subsequent distribution of those profits to Australian shareholders results in fully taxable unfranked dividends, i.e. there is double taxation, creating a tax bias against Australian shareholders owning Australian companies with significant foreign businesses (shareholders receive no relief for underlying foreign taxes);
- (iii) relevant interest expense incurred by the Australian payer is generally taxable to the recipient,⁶ therefore disallowance of the expense would in fact result in double taxation;
- (iv) investments in foreign subsidiaries create additional activities in the Australian headquarters, generating assessable income such as royalties, technical services and management fees, which may be as important or more important than NANE dividends (particularly in the early stages of an investment, e.g. dividends from investments in growth companies may not arise for many years and may not be stable or frequent); and
- (v) investments in foreign subsidiaries also give rise to taxable capital gains on disposal, where the conditions for full exemption under Subdivision 768-G exemption are not met (this is not uncommon, due to the highly prescriptive nature of the active asset test).

The proposed removal of the tax deductibility of interest relating to foreign investments does not properly take into account these effects and would create a further tax bias against productive foreign investment by Australian headquartered companies.

1.6 Any requirement to prove an Australian use of debt should be limited to entities that choose to apply the third party debt test

The Exposure Draft proposes a new “external third party debt test”, to replace the existing arm’s length debt test (ALDT) within the outward thin capitalisation rules.

Similarly to the existing safe harbour, the ALDT focusses on the Australian business and excludes shareholdings in foreign subsidiaries from the assessment of debt capacity.

The proposed third party debt test is significantly narrower than the ALDT. Among other things, it would require the borrower to use the debt “wholly” to fund Australian operations and investments.⁷

⁶ Particularly following the enactment of hybrid mismatch rules and even more so after widespread implementation of the global minimum tax rules (Pillar 2).

⁷ Proposed paragraph 820-61(2)(d).

If section 25-90 is retained in its current form (for the reasons stated in this submission) and the third party debt test is enacted in its proposed form:

- the fixed ratio test (30% of Australian tax EBITDA) would likely become the practical limit on interest deductions for most Australian headquartered multinationals;⁸ and
- only those able to trace debt to the extremely high standard of “wholly” used in the Australian business could apply the third party test to allow interest deductions above the fixed ratio.

The tracing required by the proposed third party debt test is far more severe than the tracing that was required before 2001, as it appears not to allow apportionment. For example, if most of a debt issuance is used in Australian operations and only a small part is used in foreign operations, it appears that interest on the entire debt would be non-deductible under the third party debt test.

This harsh and unreasonable result for mixed use debt could be resolved by allowing the third party debt test to apply “to the extent that” the debt is used in the Australian business. Australian headquartered multinationals that are willing and able to trace the use of all their debt could then apply the third party debt test where appropriate, while those that do not trace would be limited to the fixed ratio or group ratio, provided that section 25-90 is retained in its current form.

Even if these changes are made to the Exposure Draft, the third party debt test as currently drafted would remain inaccessible to many Australian headquartered companies, due to debt security arrangements that commonly provide lenders with recourse to both domestic and foreign assets. To balance the commercial realities of debt security arrangements with the presumed integrity objectives, we submit that instead of completely disqualifying debt that allows recourse to foreign assets, the test should allow the amount that would be lent if recourse were limited only to the assets of the Australian borrower.

2. The proposed change is not required by the OECD’s best practice recommendations

The Exposure Draft EM states that Government’s Budget announcement “was informed by the OECD’s best practice guidance” and that the amendments in the Exposure Draft legislation “align with the OECD best practice guidance.”⁹ The reference to the OECD best practice guidance is to the OECD’s BEPS Action 4 report on limiting base erosion involving interest deductions.¹⁰

The best practice recommendations in the Action 4 Report comprise three main elements:¹¹

- (i) a fixed ratio rule based on the entity’s tax EBITDA;
- (ii) a group ratio rule based on the worldwide group’s ratio of net interest expense to accounting EBITDA, applied to the entity’s tax EBITDA; and
- (iii) a range of targeted rules countries should consider, to tackle any specific BEPS risks that may remain.

⁸ Leaving aside the group ratio test, which is not addressed in this submission.

⁹ Paragraphs 1.4 and 1.8 of the Exposure Draft EM.

¹⁰ *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update (Action 4 Report)*.

¹¹ Pages 13 & 14 of the Action 4 Report.

The Action 4 Report makes the following observations on the effectiveness of EBITDA-based tests to address BEPS concerns arising from the use of debt to fund the generation of tax exempt income (emphasis added):

75. The BEPS Action Plan (OECD, 2013) specifically requires the development of rules to address base erosion and profit shifting using interest expense to fund tax exempt or tax deferred income. A third important benefit of an approach using earnings is that the definition of earnings can be adapted to exclude income which is subject to favourable tax treatment. An obvious example would be dividend income, which in many countries is exempt from tax or is taxed at a reduced rate (subject to conditions such as a minimum holding requirement).

Definition of earnings

78. In terms of the definition of earnings to be used, earnings before interest, taxes, depreciation and amortisation (EBITDA) and earnings before interest and taxes (EBIT) are both possible options. In either, non-taxable income such as branch profits or dividend income that benefit from a participation exemption should not be included in the calculation of earnings.

89. ... Tax exempt income, such as exempt dividend income or foreign earnings that are tax exempt, should not form part of the entity's EBITDA figure. The rationale behind excluding exempt dividend income is to address concerns related to the outbound investment scenario as described in Action 4.

202. The fixed ratio rule and group ratio rule should be effective in addressing base erosion and profit shifting involving excessive interest deductions and interest used to finance the production of tax exempt income. ...

These extracts show that the exclusion of tax exempt dividends from EBITDA for the purposes of the interest limitation rules should effectively address BEPS concerns arising from the use of debt to fund the generation of tax exempt income. While the OECD allows an option to implement additional rules to address such concerns, this is not required by the best practice recommendations and it is clear such rules should be appropriately targeted.¹²

This is reflected in the actual practice of the seven most closely comparable tax systems, i.e. all have an EBITDA-based limitations on interest deductions,¹³ none have a general prohibition on deductions for interest relating to exempt foreign dividends, and some have targeted anti-avoidance rules relating to debt funding (see section 3 below).

Australia's proposed total removal of deductions for interest relating to exempt foreign dividends is therefore not required. An appropriately targeted specific anti-avoidance rule should instead be considered, to address any remaining integrity concerns (see section 4 below).

3. The proposed change would make Australia an outlier relative to other major economies and decrease the competitiveness of Australian multinationals relative to global peers

Given the global mobility of capital and talent, it is important to consider the effect of the proposed amendments on the competitiveness of Australian headquartered multinationals relative to their global peers.

The Australian tax law identifies seven countries whose tax systems are considered closely comparable to the Australian system: the United States, the United Kingdom, Germany, France, Canada, Japan and New

¹² See e.g. paragraphs 103 and 173 of the Action 4 Report.

¹³ With the exception of New Zealand, as mentioned above.

Zealand (**listed countries**).¹⁴ These countries are also key investment and trading partners, highly developed economies and OECD members.

It is our understanding that all listed countries:

- provide a tax exemption (or effective exemption, e.g. dividends received deduction) for dividends received from foreign subsidiaries;
- apply or will shortly apply an earnings-based interest deduction limit of the kind recommended in the OECD’s BEPS Action 4 report;¹⁵ and
- allow deductions for interest relating to exempt foreign dividends, provided that total interest expense is less than the earnings-based limit (and subject to specific anti-avoidance rules in some cases).

The proposed amendments to section 25-90 would therefore make Australia an outlier relative to the world’s most developed and sophisticated economies, as summarised in the following table:

| | US | UK | DE | FR | CA | JP | NZ | AU Current | AU Proposed |
|--|----|----|----|----|----|----|---------------|---------------|----------------|
| Foreign dividend exemption | Y | Y | Y | Y | Y | Y | Y | Y | Y |
| Earnings-based interest deduction limitation | Y | Y | Y | Y | Y | Y | N (assets) | N (assets) | Y |
| General prohibition on deduction for interest relating to exempt dividends | N | N | N | N | N | N | N | N | Y |

Australian headquartered multinationals that are unable to trace debt to a domestic use would face an increase in their effective cost of borrowing, which would disadvantage them relative to their global peers and negatively affect their ability to grow and succeed outside Australia.

The position adopted by other major economies (and reflected in Australia’s current law) recognises that multinational groups may often prefer to borrow in their headquarter countries for many reasons, including the existence of established banking relationships, lower funding costs, access to cashflows from mature businesses and lack of tax relief for interest expense in some foreign investment locations.

It is unclear why Australian headquartered multinationals should be placed an exceptional position relative to their competitors in other major economies.

Australian headquartered multinationals already face significant additional compliance costs due to the upcoming implementation of the OECD’s Pillar 2 initiative and the implementation of a new requirement to trace the use of debt funding would only add further compliance burdens (as discussed in section 1.4).

¹⁴ See e.g. paragraph 3.4 of the EM for the *Taxation Laws Amendment (Foreign Income Measures) Bill 1997* and paragraph 4.40 of the *Review of the Foreign Source Income Anti-Tax Deferral Regimes* (Board of Taxation, 2007).

¹⁵ With the exception of New Zealand, which currently retains asset-based outward thin capitalisation rules, similar to Australia’s. Canada is in the process of enacting an earnings-based limit.

4. Any remaining integrity concerns should be addressed by an appropriately targeted measure, rather than total removal of section 25-90 deductions

To the extent that the proposed amendments to section 25-90 are motivated by integrity concerns, these should be identified and dealt with by appropriately targeted measures. This was foreshadowed in 2013 when the earlier proposal to repeal section 25-90 was abandoned (see section 1.1 above), but ultimately was not pursued.

The following considerations should be taken into account in developing an appropriately targeted measure to address any remaining integrity concerns relating to section 25-90:

- (i) Australian headquartered multinationals cannot exploit section 25-90 via intra-group “debt loading” transactions as illustrated in the 2013 Treasury paper.¹⁶ This is because they do not have a foreign parent and their transactions with foreign subsidiaries are constrained by Australia’s CFC rules.
- (ii) Since 2013, the ability of Australian headquartered multinationals to undertake structured financing transactions has been further limited by the enactment of hybrid mismatch rules.¹⁷
- (iii) Australia’s dividend imputation (franking) system creates a strong preference for Australian headquartered multinationals to pay Australian tax instead of foreign tax, reducing their incentive to allocate interest expense to Australia.
- (iv) As there are already many integrity provisions in the tax law, any additional integrity rules should be appropriately targeted to address the particular concerns not already dealt with by the existing law.

¹⁶ Section 3.4 of the 2013 Treasury Paper.

¹⁷ Division 832 and corresponding laws in other major countries.

Appendix History and rationale of section 25-90

To understand the systemic role of section 25-90, it is necessary to understand the history of the relevant provisions, which were introduced in 2001.

Pre-2001 position

Before 2001:

- (i) dividends received by Australian companies from foreign subsidiaries were exempt income under former section 23AJ;
- (ii) interest expense relating to such income was non-deductible under section 8-1; and
- (iii) Australian headquartered multinationals were not subject to any form of thin capitalisation rule.

Under this regime, it was necessary to trace the use of borrowed funds to determine whether the relevant interest expense related to Australian operations (and was therefore deductible) or related to investments in foreign subsidiaries (and was therefore non-deductible).

New regime enacted in 2001

In 2001, the current thin capitalisation rules were introduced along with section 25-90. From that time:

- (i) dividends received by Australian companies from foreign subsidiaries continued to be exempt under former section 23AJ;
- (ii) interest expense relating to such income became deductible under section 25-90; and
- (iii) Australian headquartered multinationals became subject to new outward thin capitalisation rules, which placed an upper limit on interest deductions based on the level of debt relative to Australian assets.

The relevant Explanatory Memorandum (EM) explained these changes as follows (emphasis added):

1.99 Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. These debt deductions, provided they are otherwise allowable under the general deduction provisions, will come within the scope of the thin capitalisation regime when determining the amount to be allowed.

1.100 The relevant debt deductions are those incurred in earning foreign income that is exempt income under sections 23AI, 23AJ and 23AK of the ITAA 1936. ... [*Schedule 1, item 16, section 25-90*]

3.3 An Australian entity may invest overseas via an investment in a foreign entity that it controls or by carrying on a business at or through an overseas branch. In a similar manner to foreign entities, an Australian entity with offshore operations in either form can allocate excessive amounts of debt to its Australian operations to maximise deductions for interest, thereby reducing tax paid in Australia. The existing thin capitalisation rules do not impose limits on the debt levels of these entities.

3.4 However, certain provisions deal with the deductibility of interest expenses for outward investors. These are contained in section 8-1 of the ITAA 1997 and sections 79D and 160AFD of the ITAA 1936. The rules in section 79D prevent a foreign loss being deducted from domestic assessable income and section 8-1 denies deductions incurred in earning exempt (foreign) income. However, because all of these rules rely on tracing the use of

borrowed funds, it is relatively easy to circumvent their operation by establishing a use of funds that ensures deductibility.

3.7 The new thin capitalisation regime will impose a limit on the extent to which the Australian operations of Australian outward investors can be funded by debt. Accordingly, the current limitations imposed by section 79D and section 8-1 (in relation to exempt income) on interest deductions will be removed in so far as they apply to debt deductions and do not relate to an entity’s overseas permanent establishment. Therefore, expenses relating to those deductions will be able to be deducted when incurred in earning exempt foreign income and will no longer be quarantined, subject to the limits imposed by the new thin capitalisation provisions.

| <i>New law</i> | <i>Current law</i> |
|---|--|
| Outward investing entities will have their debt deductions reduced if their debt level exceeds a maximum level. Either a safe harbour or an arm’s length test sets the maximum debt level. | The debts of an outbound investor are traced to an end use to determine the treatment of the interest expense. The interest expense can be denied or quarantined when it is incurred in earning foreign income. |
| The measures apply to Australian entities that have controlled foreign investments or permanent establishments overseas as well as to inbound investment. | The thin capitalisation measures only apply to foreign controlled Australian entities and to foreign investors deriving Australian assessable income. |

3.15 In determining whether an entity has breached the safe harbour or the worldwide gearing rule (where available), the gearing level of the entity’s net Australian assets will be tested. Australian assets consist of the entity’s total assets (other than assets attributable to any of its foreign permanent establishments) less its equity and debt investments in its controlled foreign entities. Certain other amounts are subtracted to arrive at the entity’s net Australian assets.

These extracts clearly show that in 2001 a policy decision was taken to end the requirement for Australian headquartered multinationals to trace the use of debt and instead impose a new limit on their interest deductions via the outward thin capitalisation rules. This was implemented by enacting section 25-90 together with Subdivision 820-B (thin capitalisation rules for outward investing entities).

The decision made in 2001 originated from the 1999 *Review of Business Taxation (RBT)*, whose final report stated as follows (emphasis added):

Recommendation 22.5

(a) That Australian multinational investors holding non-portfolio investments in controlled foreign entities or offshore permanent establishments be subject to thin capitalisation gearing limits on their Australian operations.

...

Recommendation 22.6

That upon adoption of Recommendation 22.5, the current law be amended so that interest expenses incurred in earning foreign source income are no longer quarantined.

The current law requires taxpayers to determine (by tracing and matching) expenses incurred in earning foreign source income. Interest expenses are not deductible to the extent they are incurred in deriving foreign source income that is not taxed in Australia ...

In practice, however, because of the fungibility of debt, financing of investments can be structured within company groups so as to conform with this law. The structuring can result in foreign investments being fully equity funded while interest deductions are claimed against domestic investments.

If this recommendation (together with Recommendations 22.5 and 22.8) were adopted, the thin capitalisation requirements will be the only restriction on the deductibility of interest where Australian taxpayers borrow for investment in controlled foreign entities. Compliance costs will be reduced by removing interest expenses from the operation of the current quarantining provisions.

Amendments since 2001

In 2009, the taxation of financial arrangements (TOFA) rules were enacted, including subsection 230-15(3) as a TOFA-equivalent for section 25-90.

In 2014, the regime enacted in 2001 was tightened by:

- (i) reducing the thin capitalisation safe harbour debt limit from 75% to 60% of Australian assets; and
- (ii) replacing the former section 23AJ foreign dividend exemption with section 768-5, which removed the exemption for dividends on shares treated as debt for Australian tax purposes.¹⁸

Ahead of this tightening, in 2013 a proposal was also made to repeal section 25-90. Based on the Treasury paper issued at the time,¹⁹ the proposal was motivated by integrity concerns (emphasis added):

24. ...[Section 25-90] was introduced with the 2001 thin capitalisations reforms as a compliance saving measure. However, as mentioned above there is now evidence that it is being used as a central step of an aggressive tax scheme. Consistent with general tax principles, entities will now need to establish a link between the interest expense and assessable income.

36. As mentioned above, while originally intended as a compliance saving measures, the evidence shows that the provision is being used as a means to shift profits out of Australia. Therefore, the Government considers that the compliance benefits of section 25-90 are outweighed by the risks to the integrity of the corporate tax base.

Appendix – Operation and policy intent of existing law

8. Section 25-90 was introduced as a compliance saving measure at the same time as the 2001 thin capitalisation reforms on the basis that the thin capitalisation rules would be the sole determinant of interest deductibility. The introduction of section 25-90 removed the requirement for taxpayers to trace interest expense deductions to the funds borrowed.

Ultimately, the proposed repeal of section 25-90 did not proceed for the reasons announced in late 2013 as follows (emphasis added):

The Coalition will not proceed with Labor's proposal to deny deductions made under section 25-90 of the *Income Tax Assessment Act 1997* because the revenue is essentially unrealisable and it would impose unreasonable compliance costs on Australian businesses. Australian companies have been able to claim deductions for interest and other debt-related expenses for their overseas investment, thanks to a Coalition measure in 2001, and will be

¹⁸ Per paragraph 2.5 of the relevant EM: "This has led to unintended consequences arising from the interaction of the thin capitalisation rules, the core tax rules for determining what is debt and what is equity (the debt equity rules) and the exemption. This arises in circumstances where an Australian company uses a 'debt instrument' which also qualifies for the exemption to fund an offshore expansion. Offshore acquisitions effected in this way are currently unconstrained by the thin capitalisation rules contrary to the initial policy intent."

¹⁹ *Addressing profit shifting through the artificial loading of debt in Australia – Proposals Paper* (14 May 2013).

able to continue to do so now that the Coalition will not proceed with this measure. We will instead introduce a targeted anti-avoidance provision after detailed consultation with stakeholders.²⁰

A senior Treasury official later commented on this in Senate Estimates (emphasis added):

I think it is fair to say that, through public consultation on that, it became apparent that the proposal that stood would not be a sensible proposal to proceed on ... With the benefit of further information, people actually work in that world and deal with that. It became apparent that the balance, which I certainly thought was out there, was incorrect. And I think it would be fair to say that any discussion with a person who is reasonably aware of these issues in this area of the tax community would say, 'I understand the point you are trying to get at; this is not the way to get at it.'²¹

The targeted anti-avoidance provision mentioned in the late 2013 Government announcement was not subsequently pursued.

²⁰ Joint media release by the Treasurer and Assistant Treasurer, 6 November 2013.

²¹ Mr Rob Heferen, Treasury Executive Director, Senate Estimates, 5 June 2014.