AVCAL

The AUSTRALIAN PRIVATE EQUITY & VENTURE CAPITAL ASSOCIATION Limited

By email – thincapitalisation@treasury.gov.au
Mr Michael Atfield
Manager
International Tax Integrity Unit
The Treasury

12 July 2013

Dear Mr Atfield

AVCAL welcomes the opportunity to comment on the Treasury's discussion paper 'Addressing profit shifting through the artificial loading of debt in Australia'.

AVCAL urges the Board to use the opportunity presented by this review to ensure that Australia presents to local and international investors, an efficient and competitive environment for the financing and funding of investments, particularly those of the private equity (PE) and venture capital (VC) industries.

Worldwide gearing test

We support the expansion of the current worldwide gearing test to inbound investors. Our submission seeks to comment on matters associated with implementing a worldwide gearing test for inbound investors within the thin capitalisation rules.

International tax rules need to give equal certainty and apply consistently to both outbound multinational enterprises and inbound investors.

AVCAL is of the view that the principles of the current worldwide gearing test can be applied not only to outbound investors but also to inbound investors. However, as outlined in our detailed submission below, some additional legislative drafting will be required to apply the current worldwide gearing test appropriately and to achieve the policy intent.

Section 25-90

AVCAL notes that no consultation has been sought in relation to the proposed repeal of section 25-90 of the *Income Tax Assessment Act 1997*. For the record, AVCAL shares the concerns of corporate Australia and industry groups that this proposal is a significant retrograde step, particularly if not tempered with transitional rules.

AVCAL is concerned that the proposal is not, in the context of the tax legislation as a whole, and the tax policy rationale underpinning them, intellectually sound. Where specific identified integrity concerns have been identified, specific anti-avoidance counter measures may be appropriate in lieu of a broad repeal of this fundamental measure.

AVCAL would welcome an opportunity to provide more specific input in the debate.

Yours sincerely

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Discussion Paper Chapter 4.1.1: Extending the worldwide gearing test to inbound investors

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The following sets out AVCAL's submission on Chapter 4.1.1 of the Board of Taxation's discussion paper 'Addressing profit shifting through the artificial loading of debt in Australia'.

References below to the worldwide gearing test in the "outbound context" are references to the current rules in section 820-110 of the Income Tax Assessment Act 1997.

Consultation Questions

Question 1: What, if any, modifications need to be made to the existing worldwide gearing test in order for it to apply to inbound investors?

AVCAL is of the view that the principles of the current worldwide gearing test can be applied not only to outbound investors but also inbound investors. However, some additional legislative drafting will be required to apply the current worldwide gearing test appropriately and to achieve the policy intent.

The following principles should be adopted in drafting a worldwide gearing test in the inbound context:

1. **The worldwide gearing test in the inbound context should as closely as possible reflect the policy intentions and application of the worldwide gearing test in the outbound context. The thin capitalisation rules should not create a bias in favour of either inbound or outbound investors.**

   The existing worldwide gearing test attempts to ascertain the gearing of an outward investing entity's worldwide group through the definitions of "worldwide debt" and 'worldwide equity" (as defined in section 995-1 of the *Income Tax Assessment Act 1997* ("ITAA 1997")). This currently results in (broadly) all of the issued debt and equity of the relevant outward investing entity being taken into account, as well as all of the issued debt and equity of the controlled foreign entities of the outward investing entity (excluding any inter-entity debt or equity).

2. **The non-Australian entities for which the worldwide debt and worldwide equity amounts are to be ascertained should be those entities which have an ultimate common foreign controller to the Australian taxpayer and the ultimate common controller itself ("Common Control Group").**

   The current outbound worldwide gearing test ascertains the relevant reference entities for which worldwide debt and equity amounts are to be calculated based on whether those entities are "controlled foreign entities" for thin capitalisation purposes. In the inbound context, it is the taxpayer itself which is the controlled entity for those purposes.

   Similar to the outbound rules, the inbound worldwide gearing test should ascertain the relevant reference entities with respect to a control relationship which exists between the taxpayer and the non-resident entities.

3. **A common foreign controller should be a single foreign entity which, by itself, causes the Australian taxpayer to be "a foreign controlled Australian company", trust or partnership for Australia's thin capitalisation rules.**

   Under the current outbound worldwide gearing test, all controlled foreign entities of the taxpayer are reference entities for the ascertainment of the worldwide debt and equity amounts. Importantly, these reference entities are determined based on a single common control relationship as between the

taxpayer (i.e. the outbound investor) and the controlled foreign entities.

Similarly in the inbound context, the reference entities for the ascertainment of the worldwide debt and equity amounts should be determined based on a single common control relationship.

In our view, the definitions of "worldwide debt" and "worldwide equity" in respect of an inward investment vehicle should capture debt and equity issued by a single foreign controller (if any) who qualifies the relevant inward investing entity as being subject to Australia's thin capitalisation rules. Accordingly, the gearing levels of that foreign entity and their controlled foreign entities should be taken into account for the purposes of determining the gearing of the worldwide group of the taxpayer.

This would be consistent with the current policy intention of the worldwide gearing test (in the outbound context) which is to allow an Australian entity to be geared to the same extent as its worldwide group (singular).

Where there are a number of foreign entities taken to control the relevant inward investor, it may be inappropriate to apply the worldwide gearing test as it would require an analysis of multiple common controllers and therefore multiple worldwide groups. These multiple worldwide groups would likely have no common basis as between each other in respect of their gearing levels.

In addition, the compliance costs and administrative burden of identifying the controlled entities of multiple foreign controllers, and the debt and equity levels of these entities, would be prohibitive.

Appropriate drafting of the concept of a 'common foreign controller' for the purposes for the inbound worldwide gearing test would necessarily be required. Consultation with industry groups should be undertaken to derive an appropriate approach in relation to the identification of the single common foreign controller.

We note that under the current outbound rules, an entity would be considered a "controlled foreign company" where there is a single Australian entity which holds an associate inclusive control interest in the company of at least 40%, and the company is not controlled by any other entities (section 340 of the *Income Tax Assessment Act 1936*). Given our recommendation below that the calculation relies on financial statements, we suggest that a simple approach may be to refer to the accounting standards.

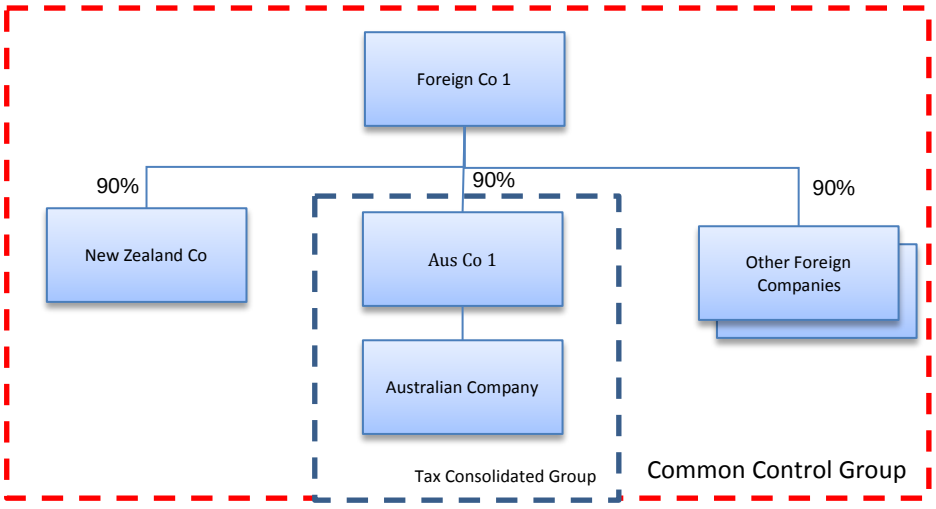
In this regard, we note existing AIFRS requires Australian reporting entities to identify its "ultimate parent" by way of note disclosure in its annual financial statements. Typically, control will only arise on shareholding interests above 50%, though actual control may arise at lower shareholding interests.

<u>Example 1</u>

Foreign Co 1 owns 90% of Aus Co 1. Foreign Co 1 should be regarded as the common foreign controller.

Foreign Co 1 owns 90% of New Zealand Co and other foreign companies. Foreign Co 1, New Zealand Co and the other foreign companies should be part of the Common Control Group.

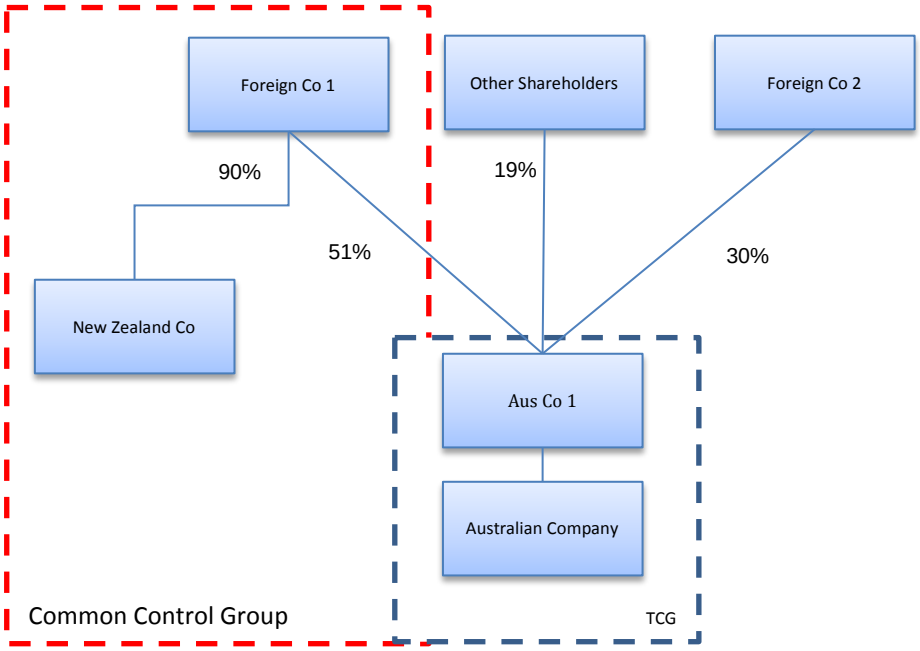
This example has been prepared on the basis that Foreign Co 1 does not itself have a single foreign controller.



Example 2

Foreign Co 1 owns 51% of Aus Co 1. Foreign Co 2 owns 30% of Aus Co. Foreign Co 1 should be regarded as the common foreign controller (on the basis that Foreign Co 1 does not itself have a single foreign controller).

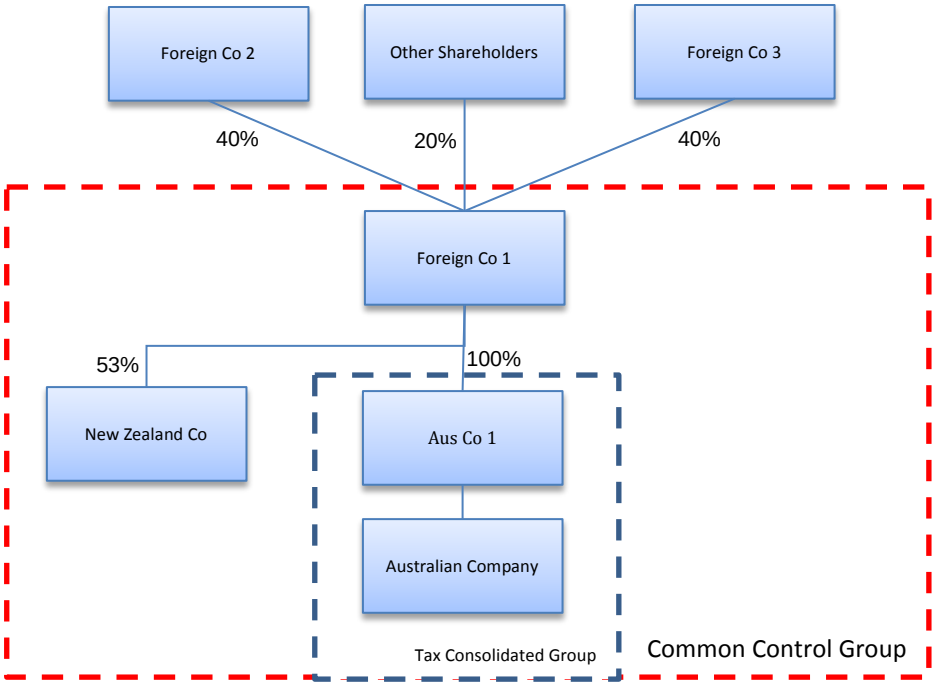
Foreign Co 1 owns 90% of New Zealand Co. Foreign Co 1 and New Zealand Co should be part of the Common Control Group.



Example 3

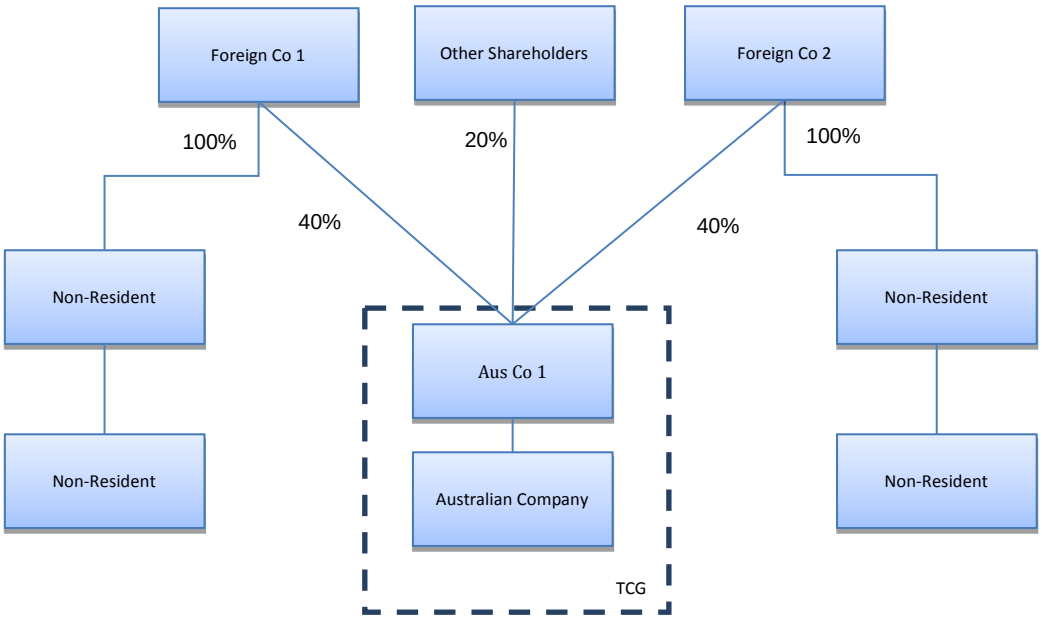
Foreign Co 1 owns 100% of Aus Co 1. Foreign Co 2 and Foreign Co 3 each own 40% of Foreign Co 1. Foreign Co 1 should be considered the common foreign controller as neither Foreign Co 2 or Foreign Co 3 controls Aus Co 1.

Foreign Co 1 owns 53% of New Zealand Co. Foreign Co 1 and New Zealand Co should be part of the Common Control Group.



Example 4

Foreign Co 1 and Foreign Co 2 each own 40% of Aus Co 1. As there is no single common foreign controller of Aus Co 1, there should be no Common Control Group for the purposes of the inbound worldwide gearing test.



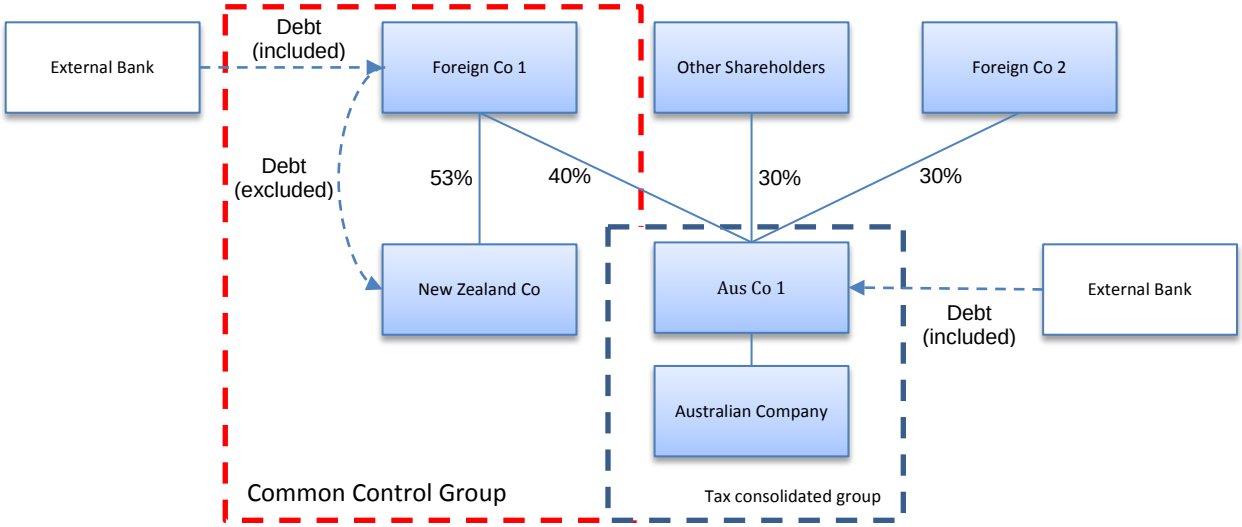
4. **The worldwide debt amount should include all interest bearing debt of the members of the Common Control Group other than debt issued amongst the members of that Common Controlled Group.**

Under the current outbound worldwide debt test, debt issued between controlled foreign entities is excluded from the ascertainment of the worldwide debt and equity amounts.

Similar rules for inward investors may be considered appropriate in certain circumstances, such as in the context of a multinational corporate group where external debt is often centralised (e.g. at the level of the foreign parent or treasury entity) or otherwise easily identifiable. In these circumstances, any inter-entity debt which otherwise reflects the levels of external borrowings would not need to be included as the relevant external borrowings can be directly factored into the worldwide gearing calculation.

<u>Example 5</u>

External debt borrowed by Foreign Co 1 and Aus Co should be included in the worldwide debt amount. Inter-entity debt between Foreign Co 1 and New Zealand Co should be excluded.



5. **The worldwide equity amount should exclude all equity issued between members of the Common Controlled Group.**

   As noted above, in keeping with the current policy intentions and application of the worldwide gearing test in the outbound context, the worldwide gearing test in the inbound context should exclude all equity issued between members of the Common Controlled Group.

6. **Mere associates of a Common Controller should not be included within a Common Controlled Group. Debt and equity issued by a Common Controlled Group to an associate of the Common Controller should not be excluded from the analysis.**

   As noted above, under the current outbound worldwide gearing test, debt and equity issued by controlled foreign entities to entities other than the taxpayer or other controlled foreign entities are not excluded from the analysis of the worldwide debt and equity amounts.

   Similarly, the worldwide gearing test in the inbound context should reflect the current application of the worldwide gearing test to only exclude debt and equity (i) issued between foreign entities which are within the Common Control Group or (ii) are issued between Australian entities in the Common Control Group.

Question 2: Are there any additional compliance costs (when compared to an outbound investor) from applying a worldwide gearing test for an inbound investor?

7. An Australian taxpayer may be a member of a large Common Control Group. The number of separate legal entities which require analysis in respect to worldwide debt and equity amounts may be extensive.

8. As a controlled entity rather than a controller, the inbound investor (i.e. Aus Co 1) may not have access to the relevant information in as timely and efficient manner as outbound investors which control the relevant foreign entities.

9. Consequently, reliance on the test should be available on an elective basis.

Question 3: If so, what are the increased costs attributed to and how can they be ameliorated?

10. **A taxpayer should be able to rely on the financial statements prepared by members of a common control group in ascertaining the worldwide debt and equity amounts. A taxpayer should be able to rely on the consolidated financial statements of a common controller (where available in ascertaining the worldwide debt and equity amounts).**

    The current outbound rules apply in the context of the taxpayer having a control relationship over the relevant foreign entities. Such a control relationship implies a level of access to accurate information upon which the taxpayer can undertake the required analysis under the outbound test.

    In the inbound context, the implication does not necessary hold true in respect of the taxpayer being a controlled entity rather than a controller. As such, it may not always be feasible or possible for the taxpayer to have sufficient access to detailed trial balances and financial information.

    In addition, the current outbound rules ascertain the worldwide debt and equity amounts by reference to the characterisation of such interests under the debt/equity rules contained in Division 974 of the ITAA 1997.

To assist taxpayers to comply with obligations under the worldwide gearing test in the inbound context, taxpayers should be given the option to rely on financial statements which have been prepared in accordance with appropriate accounting standards and principles in ascertaining the worldwide debt and equity amounts.

11. **A taxpayer should be able to undertake the analysis of the worldwide debt and equity amounts with reference to balance dates occurring within its income year but which coincide with the accounting balance date for the relevant member of the Common Controlled Group.**

    The current outbound rules apply in the context of the taxpayer having a control relationship over the relevant foreign entities. Such a control relationship, particular in a consolidated accounting context, implies a reasonable level of alignment of accounting balance dates.

    In the inbound context, the implication does not necessarily hold true in respect of the taxpayer being a controlled entity and where the taxpayer has not adopted a substituted accounting period. Further to our comments above in the context of access to appropriate financial information, it may not always be feasible or possible for the taxpayer to have sufficient access to financial information at a balance date which aligns with the measurement dates for the purposes of Australia's thin capitalisation rules.

    Subject to appropriate integrity measures and limitations, a taxpayer should be able to undertake the analysis of the worldwide debt and equity amounts with reference to the accounting balance dates of members of the Common Control Group.