Australia's federal budget measures could affect US multinationals investing in Australia

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In brief

The Australian 2013 – 2014 federal budget, released on May 14, 2013, contains a number of measures aimed at increasing Australian tax revenue. Several of the proposals may be relevant for inbound and outbound investors in Australia. Most notably, the budget proposes to amend the Australian thin capitalization rules by reducing the safe harbor debt amount from 75% to 60% of adjusted Australian assets (an effective debt/equity ratio of 1.5:1 compared to the current 3:1 ratio).

The budget also contains proposals to limit the deductibility of Australian debt raised for foreign investments and to remove the existing participation exemption for dividends received from foreign companies on shares that, for Australian tax purposes, qualify as debt interests under the Australian debt/equity rules.

Most of the proposals discussed below are set to apply for tax years commencing on or after July 1, 2014. This would defer the proposals' application for companies with a calendar year end to the year beginning January 1, 2015.

In detail

Tighter thin capitalization regime to limit Australian debt deductions

Generally, for foreign controlled Australian entities (inbound), and Australian companies with foreign investments (outbound), the current thin capitalization threshold is a debt level of 75% of the entity's adjusted Australian assets (safe harbor debt test), or an arm's length level of debt. Where the debt level exceeds the threshold, interest expense deductions are disallowed. Different rules apply if the relevant entity is a financial institution.

The government proposes to:

- reduce the safe harbor debt/equity ratio for general entities to 1.5:1 (60%) and for non-bank financial entities to 15:1
- increase, for banks, the capital limit to 6% of their risk-weighted assets of the Australian operations
- reduce, for outbound investors that do not satisfy the safe harbor test, the allowable Australian gearing to 100% of the group's worldwide debt/equity ratio (from 120%). This would also be available to inbound investors
- increase the existing de minimis threshold from A$250,000 to A$2 million of debt deductions.

Although the existing arm's-length test would remain, the government would review it with the goal of making it easier to comply with and administer.

Government addresses tax rules on debt funding foreign investment

The government proposes to remove the deductions currently available for interest expense related to investments in foreign companies that generate exempt dividends.

Observations

This is a significant change that the government says is the third part of a package of measures designed to tackle "artificial loading of debt in Australia by multinationals."

This conclusion understates the importance of this provision to Australian-based companies investing offshore and does not address the context of the reforms to Australia's tax system made more than a decade ago. Hopefully the government's promise to consult with industry on this measure will improve the proposal. The proposal, in its current form, would place Australian multinational companies at a significant competitive disadvantage internationally.

Remove exemption for certain dividends

The government proposes to remove the income tax exemption for dividends received by Australian companies in relation to certain interests in foreign companies when that interest is classified as 'debt' for Australian tax purposes.

Currently, the exemption is available for dividends received from all 'non-portfolio' interests in foreign companies (i.e., interests of 10% or more) that are legal-form shares. The proposed amendment would remove the exemption for legal-form shares that are treated as debt interests for Australian tax purposes under the Australian debt/equity rules. Examples of such shares include certain types of mandatorily redeemable preference shares.

The announcement does not indicate whether the proposal would change the treatment for interest payments on legal-form debt interests that are treated as equity for Australian tax purposes.

On a taxpayer-favorable note, the government also proposes to extend the existing participation exemption for non-portfolio dividends to dividends received through partnerships and trusts.

Changes to non-resident capital gains tax

The government proposes amendments related to "indirect Australian real property interests" for capital gains tax purposes, effective as of the budget announcement date (May 14).

Under this amendment, non-residents that recognize intercompany receivables would be restricted from using these intercompany receivables to prevent triggering of an Australian capital gains tax liability.

Another amendment would value mining, quarrying, and prospecting information and goodwill together with the mining rights to which they relate. This amendment would prevent non-residents from excluding certain mining information when determining indirect Australian real property assets.

The government also proposes that effective July 1, 2016, a 10% non-final withholding tax would apply to disposals by foreign residents of certain "taxable Australian property".

Government focuses on mining operations

The government has proposed limits on what it sees as 'significant' tax concessions available to mining operations in Australia.

Change in the timing of deductions for mining rights and information

Currently, the cost of a depreciating asset (including exploration permits and mining information as defined in the tax legislation) that is first used for exploration can be deducted immediately. The government proposes to depreciate mining rights and mining information that are first used for exploration over the shorter of their effective life or 15 years. If exploration is unsuccessful, the remaining value of the right, and associated information, could be deducted when the exploration's failure is determined.

To ensure that exploration activity continues to benefit from the immediate deduction, the government has targeted the measure so that only the cost of depreciating assets involved in what it considers to be 'genuine exploration activity' would continue to be deductible immediately.

The proposed changes would apply to taxpayers that start to hold the mining, quarrying, prospecting right, or information after May 14, 2013, unless the taxpayer has committed to the acquisition before May 14, 2013, or they are deemed under the tax law to already hold the right or information before this time.

Australian Tax Office (ATO) focuses on offshore marketing hubs

The government will increase ATO funding so that it can review offshore marketing structures.

Changes to the tax consolidation regime

The government proposes measures to prevent foreign investors from taking advantage of the rules relating to multiple entry consolidated (MEC) groups. The unjustified advantages identified by the government include the ability to make tax-free transfers of assets between members of an MEC group and subsequent tax-free disposals. While the measures to equalize the treatment of MEC and ordinary consolidated groups would apply effective July 1, 2014, the government reserves the right to make the legislation effective earlier, potentially from the date of the budget announcement date, with regard to what it identifies as aggressive tax minimization strategies involving MEC groups.

Review of the debt/equity rules

The government is planning a post-implementation review of the Australian debt/equity rules, which were enacted in 2001. The review will examine whether the rules can address any inconsistencies between the debt/equity rules of Australia and other countries.

The takeaway

Companies that might be affected by the proposed changes should study the legislation when it is released. Where possible, PwC will continue to monitor the legislative proposals.

US groups with Australian investments should re-assess their position under the thin capitalization rules and the proposed interest deduction limitation to determine the impact on interest expense deductibility in Australia. Furthermore, US companies should assess whether the arm's-length debt test may provide a better result.

To the extent a group's global debt level exceeds 60% of its adjusted global assets, there may be an opportunity to apply the worldwide gearing test to calculate the amount of deductible debt in Australia.

Mining companies with Australia operations should consider how the change in timing of depreciation deductions for mining rights and information could affect cash-flow forecasts.

Let's talk

For a deeper discussion, please contact:

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