Australia releases draft reforms to thin capitalization and dividend exemption rules

May 12, 2014

In brief

The Australian Treasury on May 8, 2014, released exposure draft legislation to reform Australia's thin capitalization and dividend exemption rules. The changes previously had been announced in the 2013-14 Australian Federal Budget.

The proposed thin capitalization amendments would tighten the deductible debt limits from a debt-to-equity ratio of 3:1 to 1.5:1, increase the de minimis ratio, and make the worldwide leverage ratio test available to both Australian inbound and outbound groups. The new thin capitalization rules are expected to apply for income tax years that begin on or after July 1, 2014. Thus, for companies with December 31 year-ends, the rules would apply January 1, 2015.

The proposed dividend exemption amendments would reform the exemption for non-Australian non-portfolio dividends received by an Australian company. They are designed to address perceived integrity issues by excluding the exemption for shares that are debt interests for Australian tax purposes and allowing the exemption to apply when distributions flow through trusts and partnerships.

The Treasury also proposes to eliminate the taxpayers' ability to pool portfolio dividends in a foreign company to qualify for the non-portfolio dividend exemption.

US multinational corporations (US MNCs) should consider the amendments' possible impact on tax relief for their interest expenses and foreign dividend receipts in Australia if the proposed changes are implemented.

The deadline for comments on the exposure draft and explanatory memorandum is June 6, 2014.

In detail

Current thin capitalization rules

The current Australian thin capitalization rules disallow a proportion of otherwise deductible debt-related expenses when the debt allocated to an MNC's Australian operations exceeds certain limits.

Generally, for non-Australian tax resident entities with Australian subsidiaries, the current thin capitalization threshold for the Australian operations is the greater of:

- a debt level of 75% of adjusted Australian assets (the 'safe harbor debt test'); or
- a debt level that a third-party lender generally would find acceptable (the arm's-length debt test).

A third test may be available for Australian tax-resident entities with foreign subsidiaries. This additional test limits deductible debt in the Australian operations to the greater of the results under the above two tests, or 120% of the level of the worldwide group's leverage (worldwide leverage ratio).

Different rules apply if the relevant Australian entity is a financial institution.

Proposed thin capitalization amendments

The proposed thin capitalization amendments would:

- reduce the safe harbor debt limit from 75% of adjusted Australian assets to 60% for 'general' entities (effectively reducing the maximum safe harbor debt-to-equity ratio of 3:1 to to 1.5:1) and from 20:1 to 15:1 for certain 'financial' entities
- increase the de minimis threshold exemption for application of the thin capitalization rules from $A250,000 to $A2 million of debt deductions
- extend the worldwide leverage test to foreign controlled Australian companies of multinational groups
- reduce the worldwide leverage ratio from 120% to 100%
- increase the safe harbor capital limit for authorized deposit-taking institutions (e.g. certain financial institutions) from 4% to 6% of their risk-weighted Australian assets.

As previously announced, the proposed amendments would apply to income tax years commencing on or after July 1, 2014. There are no transition provisions.

Dividend exemption rules

Under current law, a dividend received by an Australian company from a 'voting interest' of 10% or more in a foreign company is treated as non-assessable, non-exempt income.

Because the exemption focuses on 'voting interest,' some returns on instruments that are debt instruments for tax purposes (e.g., mandatorily redeemable preference shares) may be eligible for the current exemption.

The exemption does not apply to dividends that flow through interposed trusts or partnerships or apply with respect to non-share distributions.

The proposed amendments would repeal and replace the existing dividend exemption section; the exemption would apply when:

- an Australian company holds a participation interest of at least 10% in a foreign company; and
- a foreign equity distribution is made with respect to an equity interest in a foreign company.

When an entity satisfies these conditions, the new exemption also would apply to:

- distributions made with respect to non-share dividends; and
- dividends that flow through an interposed trust or partnership, but not a corporate tax entity.

The proposed amendments would eliminate the ability to pool portfolio and non-portfolio dividends in an offshore entity to qualify for the exemption on repatriation to Australia.

As currently drafted, the proposed amendments are expected to apply after the date of Royal Assent.

The takeaway

US MNCs should review their Australian thin capitalization position, given the proposed effective date of the amendments. MNCs applying the 'safe harbor debt test' should consider whether a lowered thin capitalization threshold would result in non-deductible interest and whether they should consider applying the alternative thin capitalization tests, such as the worldwide leverage ratio.

Taxpayers likely to be adversely affected by the proposed amendments should consider making a submission on the exposure draft and explanatory memorandum. Submissions can be made through June 6, 2014.

Let's talk

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

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