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The Treasury

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Attention: Greg Wood

Dear Sir

# Improving the integrity of the thin capitalisation rules

We refer to the Exposure Draft of Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Bill 2018 issued on 1 August 2018, further to the announcements made as part of the 2018-19 Federal Budget.

We welcome the opportunity to comment on this matter, and in particular, with respect to the proposal “requiring entities to align the value of their assets for thin capitalisation purposes with the value included in their financial statements”.

Subsection 820-680(1) of the Income Tax Assessment Act 1997 (ITAA 97) lays out the general rule that the determination and valuation of assets, liabilities, debt capital and equity capital (collectively referred to as “subsection (1) matters”) must be done in a way that complies with accounting standards.

Proposed new Subsection 820-680(2) provides that if “an entity is required by an Australian law to prepare financial statements for a period in accordance with the \*accounting standards”, and a subsection (1) matter is “determined or calculated in accordance with the accounting standards for the purposes of the financial statements in relation to the period”, then the subsection (1) matter is to be determined or calculated [query for Treasury: should that be “determined and calculated”] as per the financial statements.

We have two points to raise in this respect:

1. The proposed structure creates a thin capitalisation bias against companies that are required to prepare Australian financial statements as against companies which are not so required. This bias should be eliminated; and
2. Based on the linkages to financial statements in the current framework, there will be mismatches and gaps due to what is “determined” or “calculated” in the accounts required to be prepared from a financial reporting perspective will often be different from what is required to be “determined” or “calculated” from a taxation, thin capitalisation calculation, perspective. This will, at the least, create uncertainties when taxpayers refer to financial statements for the purposes of Division 820.

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It will often be the case that the relevant taxpayer group differs to the group for which financial statements are prepared.

We submit that this proposed framework gives rise to a potential differentiated tax outcome arising as a result of a matter that is exogenous to the tax law: the requirement or otherwise to lodge financial statements is prima facie a matter for the Corporations Law.

This is of particular concern for listed Australian groups, which, we expect, will be treated as being “required by an Australian law” to prepare financial statements in accordance with accounting standards: being their published accounts. Where the listed Australian group is subject to the thin capitalisation rules

(eg, the listed company parent as the head entity of a tax consolidated group performs the thin capitalisation calculation) and it is able to revalue say, plant and equipment having regard to accounting standards, it would be required to include that valuation in the published accounts under the proposed rules in order to adopt that revaluation in its thin capitalisation calculation. The group may not do so for commercial, accounting, industry practice or other reasons.

In contrast, there will be other cases including a foreign multinational group with Australian operations which may not be required by an Australian law to prepare financial statements for the Australian group, or if so required, may be less constrained about including such a revaluation in its financial statements. Hence there is a greater ability for a foreign owned group to reflect a revaluation of plant and equipment in its thin capitalisation calculations.

Hence the proposed law prejudices outbound listed Australian groups. It is submitted that this is not an equitable outcome as between taxpayers and should be eliminated.

In addition, it is submitted that difficulties will arise where the “entity [that] is required by an Australian law to prepare financial statements for a period in accordance with the \*accounting standards” (subsection 820-680(2)) differs to the entity referred to in subsection 820-680(1), being the entity that is subject to Division 820. This will often be the case.

Having regard to the single entity rule with respect to tax consolidated groups and MEC groups, the entity that is subject to Division 820 is the head entity or provisional head entity. As per TR2004/11: “The principle underlying the SER is to treat a consolidated group as a single entity, with the head company being that entity for income tax purposes. To this end the SER deems the subsidiary members of the consolidated group to be parts of the head company rather than separate entities”.

There will be many cases where the group of companies that is covered by the required financial statements differs to the group of companies that are in the tax consolidated group or MEC group. For example, some of these cases are noted below (there will be others):

|  |  |  |
| --- | --- | --- |
|  | **Financial statements prepared for**  | **Tax entity**  |
| 1  | Ausco, on a standalone basis (non-consolidated) showing an investment asset (shares) in its 100% owned Australian subsidiaries  | Ausco as head entity of the tax consolidated group (consisting of Ausco and all of its 100% owned Australian subsidiaries)  |
| 2  | Ausco, all of its 100% owned Australian subsidiaries and its other controlled (but <100%) Australian subsidiaries  |
| 3  | Ausco and all of its 100% owned Australian subsidiaries and foreign subsidiaries  |
| 4  | Ausco 1 on a standalone basis and Ausco 2 on a standalone basis  | Ausco 1 as provisional head entity of the MEC group (consisting of Ausco 1 and Ausco 2)  |

Scenario 1 is a case where the financial statements cover a group smaller than the tax consolidated group. Scenarios 2 and 3 is a case where the financial statements cover a group larger than the tax consolidated group, and scenario 4 is a case where the tax group differs to the accounting concepts.

As a result, there will be various cases of mismatches and gaps:

1. Certain subsection (1) matters could be determined and calculated in the financial statements which are not relevant for the purposes of Division 820. For example:
	* In scenario 1, the financial statements will show an asset being shares in the 100% owned Australian subsidiaries and may show a liability owing to one or other of the 100% owned Australian subsidiaries
	* In scenario 3, the financial statements will show the assets owned by the foreign subsidiaries.

Presumably these matters, although identified in the relevant financial statement disclosures are ignored for thin capitalisation purposes.

1. As a follow on in respect of scenario 1, the assets owned by a 100% owned Australian subsidiary in the tax consolidated group will be relevant to the Division 820 calculation. Those assets do not appear in the required (standalone) financial statements.

1. A further example of a “gap” arises in scenario 3, where say Ausco owns 80% of an Australian company (Ausco Affiliate) which is consolidated for accounting purposes. For the purposes of Division 820, one of the assets of Ausco is shares in Ausco Affiliate. We are concerned that the accounting standards (s820-680(1)) and the financial statements of Ausco (s820-680(2)) have addressed the shares in Ausco Affiliate and determined that there is no asset to recognise and value (as the shares in Ausco Affiliate are eliminated on consolidation for accounting purposes). The asset (shares in Ausco Affiliate) technically is at risk of being disregarded for thin capitalisation purposes.

These mismatches and gaps will – at the least – result in significant uncertainties about how to determine and value the subsection (1) matters in the thin capitalisation calculations, and could result in the nonrecognition of relevant subsection (1) matters.

It is submitted that an alternative approach is that the amounts used in the thin capitalisation calculation should be based on notional financial statements applying accounting standards for a notional group, being the actual Australian tax group for which the thin capitalisation calculation is being performed.

The reference to notional financial statements for a notional group is not requiring the preparation of any additional financial statements. Rather, the taxpayer for which the thin capitalisation calculation is being performed is treated as a notional group for accounting purposes, so that accounting standards can be applied to that group. The subsection (1) matters are determined and calculated under accounting standards as applied to that notional group.

Such information would be required on a consolidated or aggregated basis if relevant and would exclude the consolidation exemptions available to entities in certain circumstances when applying accounting standards (ie, similar to the proposed section 960-575(4) in the Exposure Draft, Treasury Laws Amendment (Measures for a later sitting) Bill 2018: significant global entities, as released on 20 July 2018).

This would operate as follows, for example:

* For a tax consolidated group:
	+ the notional group would be all members of the tax consolidated group o the subsection (1) matters are determined and calculated for the notional financial statements that could be prepared for the notional group in accordance with accounting standards
* For accounting groups consisting of a tax consolidated groups and partly owned subsidiaries that are not members of the tax-consolidated group (or foreign subsidiaries):
	+ the notional group would be only the members of the tax consolidated group
	+ the subsection (1) matters are determined and calculated as for the notional financial statements that could be prepared for the notional group in accordance with accounting standards
	+ These statements would notionally present an investment in the partly owned subsidiaries: this would overcome the issue noted at C above
* For individual entities that are taxpayers and not members of a tax consolidated group, the notional financial statements would be for the entity itself, notionally prepared in accordance with accounting standards.
* For MEC groups, the notional financial statements would consolidate and/or aggregate all members of the MEC group, and only members of the MEC group. Consolidation principles would be applied to eliminate transactions and balances between those entities, in a manner consistent with how the tax consolidation principles work when determining taxable income for the group.

Further, this approach would permit entities that are required to prepare financial statements to apply options available in accounting standards in a different way for thin capitalisation purposes, as compared to their actual financial statements. Specifically, an entity that adopts the cost basis of measurement for property, plant and equipment in its actual financial statements could elect to apply the revaluation basis for those assets in its notional financial statements if desired. This eliminates the thin capitalisation bias outlined earlier in this letter.

We would be pleased to discuss any aspect of this submission further.

Yours sincerely

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