Revenue Law Journal

Volume 8 | Issue 1 Article 9

January 1998

Thin Capitalisation Changes - Effect on Trusts

Jeff McDermid
Watter McDermid & Staff

Sheree Young
Watter McDermid & Staff

Thin Capitalisation Changes - Effect on Trusts

Abstract
The changes to Australia's Thin Capitalisation provisions introduced by Taxation Laws Amendment Bill (No 4)1997 will have an adverse impact on many foreign-controlled trusts. This article examines the implications of the changes and illustrates their effect on many common trust structures.

Keywords
capitalisation, foreign debt, trusts, Australia, income tax

COMMENTS

THIN CAPITALISATION CHANGES - EFFECT ON TRUSTS

Jeff McDermid

and

Sheree Young

Chartered Accountants
Watter McDermid & Staff

The changes to Australia's Thin Capitalisation provisions introduced by Taxation Laws Amendment Bill (No 4) 1997[1] will have an adverse impact on many foreign-controlled trusts. This article examines the implications of the changes and illustrates their effect on many common trust structures.

INTRODUCTION

The objective of the Thin Capitalisation measures is to prevent non-resident investors financing their investments excessively by in-house debts which give rise to interest deductions against Australian income. Returns on investments by way of interest payments on debts are subject to withholding tax of 10%, compared to income tax rates applied to profits, which may be as high as 47%.[2]

1 Changes to the Thin Capitalisation provisions were announced by the Treasurer in the 1996/97 Federal Budget. Draft legislation was introduced to Parliament on 26 June 1997. Taxation Laws Amendment Bill (No 4) 1997 passed through Parliament in November 1997 and at the time of writing is awaiting Royal Assent.

2 Based on the top marginal rate of tax.

Division 16F of Part III of the Income Tax Assessment Act 1936 (Cth)[3] operates to achieve this objective by restricting the tax deductions available for interest expenses in respect of debt owing to foreign controllers. Interest which is in respect of excessive foreign debt is denied a tax deduction. Excessive foreign debt is measured with reference to the level of foreign equity held by the foreign controller in the foreign-controlled entity. The ratio of foreign debt to foreign equity assists in ensuring that an appropriate amount of profit is derived in Australia, and in protecting Australia's revenue base.

Division 16F applies to foreign-controlled Australian resident companies, partnerships and trust estates, and also to direct investment by a "foreign investor", for example, by a non-resident company through a branch in Australia. Broadly, a foreign controller is a non-resident who, either alone or with associates, has a 15% or more interest in an Australian resident company, partnership or trust.

Significant changes to the thin capitalisation provisions have been introduced in Taxation Laws Amendment Bill (No 4) 1997. Subject to some transitional provisions,[4] the changes have effect from the 1997/98 income year. The structure of many existing foreign-controlled entities will no longer be viable following the change. Planning for foreign investment in Australia will need to be revisited, as the effective rate of tax of many common commercial structures which utilise trusts will rise significantly.

This article analyses the thin capitalisation provisions in relation to trusts, looks at the changes to those provisions, and illustrates their effect on existing structures.

FORMER PROVISIONS AS THEY APPLIED TO TRUSTS

Section 159GZV contains the operative provisions of Division 16F in relation to trust estates. It applies where foreign debt interest would otherwise be allowable as a deduction in calculating the net income of a trust estate under s 95.[5] The provision disallows a proportion of that interest where the greatest total foreign debt at any time during the year of income exceeds the foreign equity product of the trust estate.

---

3 Inserted by Act No 138 of 1987, applicable to assessments in respect of income of the year of income commencing on 1 July 1987 and all subsequent years of income.

4 Applicable to taxpayers with substituted accounting periods.

5 Income Tax Assessment Act 1936 (Cth) s 95(1) defines the net income of a trust estate.

"Foreign debt" in relation to a trust estate is generally calculated as the balance outstanding on any amount (owing by the trustee of the trust estate) on which interest is or may become payable to a foreign controller or non-resident associate of a foreign controller.[6]

"Foreign equity" refers to the notional equity of the foreign controller in the trust estate based on a notional balance sheet drawn at the end of the year of income.[7] The foreign equity was formerly multiplied by a factor of three, thus resulting in the foreign equity product. Other changes introduced by Taxation Laws Amendment Bill (No 4) 1997[8] have reduced the multiplying factor to two.[9]

The interest disallowed is calculated as follows:

$$\text{Foreign debt interest otherwise allowable} \times \frac{\text{Greatest foreign debt of the trust estate minus foreign equity product}}{\text{Greatest foreign debt}}$$

The result of these provisions is that interest expense attributable to foreign debt which exceeds the permitted two to one ratio is not tax deductible to the trust estate.[10]

As noted above, both foreign debt and foreign equity are calculated with reference to the interest of the foreign controller. A non-resident is a foreign controller of a trust if, inter alia:[11]

(a) the trustee of the trust estate is non-resident;
(b) the non-resident has substantial control of the voting power in a trust estate;[12]
(c) the non-resident, either alone or with associates, has a direct or indirect beneficial interest in at least 15% of the corpus or income of the trust;[13] or
(d) the trustee of the trust is accustomed or under an obligation or might reasonably be expected to act in accordance with the directions or wishes of the non-resident or associates of the non-resident.

---

6 Income Tax Assessment Act 1936 (Cth) s 159GZF(3).
7 Refer (former) s 159GZG(4) Income Tax Assessment Act 1936 (Cth).
8 Above n 1.
9 Effective from the 1997/98 Income Year.
10 Three to one for years of income up to and including 1997/98.
11 Refer s 159GZE(3) Income Tax Assessment Act 1936 (Cth).
12 Ibid at s 159GZJ(3).
13 Ibid at s 159GZH(3).

In the case of discretionary trusts, this definition cannot always be meaningfully applied. Whether a beneficiary of a discretionary trust had a direct or indirect beneficial interest in a trust was considered by the Administrative Appeals Tribunal (AAT) in Case 29/96.[14] The AAT held that both vested but defeasible interests and contingent interests were direct beneficial interests for these purposes and, in that case, the "foreign controller" test was therefore satisfied.

NEW LEGISLATION

Taxation Laws Amendment Bill (No 4) 1997 introduces changes to improve the effectiveness of the thin capitalisation rules.[15] The proposals include, inter alia, amendments to the definition of "foreign equity" for fixed trusts, and measures to deny discretionary trusts a gearing ratio to the extent their foreign equity cannot be effectively measured because of the existence of the trustee's discretion.

These measures have wide-reaching implications, not only for discretionary trusts, but also for fixed trusts that have discretionary interests in their income or capital.

The new measures achieve their objective by amending the definition of foreign equity in relation to trust estates in s 159GZG(4) and replacing it with a formula which refers to fixed interests in the equity and fixed interests in the income of the trust.[16]

The new s 159GZG(12) expands this formula in the case of discretionary trusts.[17] A new table in the legislation applies a "maximum discretionary

14 96 ATC 330.

15 Refer Explanatory Memorandum to the Taxation Laws Amendment Bill (No 4) 1997, ch 1, Purpose of the amendments.

16 Where the trust estate has no net income, s 159GZG(4A) of the Income Tax Assessment Act 1936 (Cth) applies a formula based only on the foreign controllers' interest in the equity.

17 As defined in new s 159GZG(13), ibid, as follows:

In subsection (12): **"discretionary trust"** means a trust where:

(a) both of the following conditions are satisfied:

(i) a person (who may include the trustee) is empowered (either unconditionally or on the fulfilment of a condition) to exercise any power of appointment or other discretion;

(ii) the exercise of the power or discretion, or the failure to exercise the power or discretion, has the effect of determining, to any extent, either or both of the following:

(A) the identities of those who may benefit under the trust;

(B) how beneficiaries are to benefit, as between themselves, under the trust; or

(b) one or more of the beneficiaries under the trust have a contingent or defeasible interest in some or all of the corpus or income of the trust; or percentage" which is determined with reference to the definition of discretionary trusts. The result is that the foreign equity of a trust which is a discretionary trust will be reduced to the extent of the discretionary interests in the trust's income and capital. A fully discretionary trust will thus be denied a deduction for all interest paid to foreign controllers on foreign debt.[18]

It is accepted that the former measures were difficult to apply in the case of discretionary trusts. However, it is difficult to accept that the new provisions introduce a fair and equitable measure of foreign equity for trust estates which have discretionary interests. An alternative approach would be to adopt wording that permits satisfaction of the Commissioner concerning levels of foreign equity, as is the case with s 160ZZS, or to use the same percentage calculated to identify foreign control.[19]

The definition of discretionary trusts includes other trusts where a discretionary trust may benefit or is capable of benefiting under the first-mentioned trust. This extends to fixed trusts which have interests held by discretionary trusts. Therefore, a unit trust will be deemed to be a discretionary trust where a discretionary trust has an interest in the unit trust.

The impact of these measures extends to common structures where interests in unit trusts are held by discretionary trusts. A further detrimental affect of the provisions is that a fixed or unit trust in which a discretionary trust benefits is deemed to have a maximum discretionary percentage of 100%,[20] no matter how small the discretionary interest in the fixed or unit trust is. The result is that all interest deductions will be denied.

This complete denial of interest deductions is inequitable, particularly where the majority of interests in the fixed or unit trusts are non-discretionary. This approach is also inconsistent with the other provisions in the definition of foreign equity which recognise fixed percentage interests in trusts and allow foreign equity to this extent. It is submitted that the formula should refer to the proportionate interest in the fixed or unit trust which is discretionary, and calculate foreign equity with reference to this proportion.

(c) the trustee of another trust, being a trust where both of the conditions in para (a) are satisfied, benefits or is capable (whether by the exercise of a power of appointment or otherwise) of benefiting, under the first-mentioned trust.

18 Deductions are also denied for interest on debt provided by associates of foreign controllers.

19 Refer to the submission by the Taxation Institute of Australia on the Taxation Laws Amendment Bill (No 4) 1997.

20 Refer Case 4, table of calculations of maximum discretionary percentage, s 159GZG(12) Income Tax Assessment Act 1936 (Cth).

Illustration of the Impact of the New Measures

An example of a situation addressed by the authors illustrates the inequity of these provisions:

A unit trust with majority non-resident interests has maintained debt to equity ratios within the required levels to permit deductions of interest in the calculation of net income.[21] Foreign debt is provided to the unit trust by the foreign controllers. The units in the unit trust are held by:

(1) Australian resident companies (30%);
(2) Non-resident individuals (40%); and
(3) Discretionary trusts (30%).

Pursuant to the new provisions, because a discretionary trust is capable of benefiting under the unit trust, the maximum discretionary percentage applied in the calculation of foreign equity is 100%, and thus foreign equity is reduced to nil. The result is that a debt to equity ratio cannot be satisfied, and all interest on foreign debt is denied a deduction. The impact of the after-tax rate of return and increase in the effective rate of tax is significant (the following assumes 100% foreign ownership):

	Pre-30/06/97 $	Post-30/06/97 $
Total Foreign Investment in the Unit Trust	10,000,000	10,000,000
Debt component (3:1) (a)	2,500,000	2,500,000
Net Profit before interest	2,000,000	2,000,000
Interest expense (15%)	(375,000)	(375,000)
Taxable Income	1,625,000	2,000,000
Income Tax (36%)	(585,000)	(720,000)
Interest Withholding Tax (b)	(37,500)	(37,500)
After-tax return to Foreign Investor	1,377,500	1,242,500
Effective Rate of Tax	31.11%	37.88%
Rate of Return	13.78%	12.42%

(a) Permitted ratio reduced to 2:1 however assuming no debt restructure given impact of the discretionary trust provisions.
(b) Assumes a typical loan agreement which provides for grossing up of interest paid to ensure the withholding tax is borne by the borrower.

In this case, a transfer of the units from the discretionary trust will attract significant capital gains tax and stamp duty costs. The new legislation has

[21] Level of equity is at least one quarter of the level of foreign debt, thus producing the three to one debt to equity ratio applicable to years of income up to and ending on 30 June 1997.

posed significant restraints on the existing commercial structure. As illustrated, notwithstanding that the interest expense is not tax deductible, interest withholding tax is still payable.

Many loan agreements with foreign controllers or their associates would also not provide for flexibility with the structure and rate of interest payments. Such interest expense would fall into a black hole, being subject to withholding tax, yet denied a tax deduction. The impact of the changes may mean the trust structure and the financing arrangements are no longer viable.

Any restructure of the entity to mitigate the effect of the loss of deductibility of interest expense may also fall for consideration under the general anti-avoidance provisions.[22]

The results are entirely inequitable. The effect on fixed trust structures as noted in the example was not foreshadowed in the announced proposals. Given they apply from 1 July 1997 (four days after introduction of the legislation), entities in this position will miss out on significant interest deductions in the 1998 year.[23]

CONCLUSION

The changes to the thin capitalisation measures have now introduced some draconian results. The issues raised in this article in relation to discretionary trusts, and the effect on many fixed or unit trusts, illustrate that the changes go beyond that required to clarify the position.

The new law has not only introduced a sledgehammer approach to the use of discretionary trusts for foreign investment in Australia, it also extends to widely used commercial entities. Fixed or unit trusts in which interests are held by discretionary trusts are commonly used to provide flexibility where two or more arms' length parties are involved. Any foreign investment in this structure can no longer receive a tax-effective return, even within the permitted debt to equity ratios.

Entities which are adversely affected now face the costly exercise of re-structuring, and all in the face of the anti-avoidance provisions. Investors and their advisers that are planning for new entities which incorporate foreign investment should be aware of the downfall of discretionary trusts in relation to debt funding.

---

22 Pt IVA Income Tax Assessment Act 1936 (Cth).

23 Re-structuring of the unit trust prior to 1 July 1998 may permit the thin capitalisation ratios to be complied with for the 1998/99 year.

Submissions by the professional bodies in relation to these issues during the process of this legislation were not addressed in the amendments.[24] One can only hope that the inequity brought about by these provisions will be addressed in future legislation.

24 Above n 19.