

## **Update to the Department of the Treasury's submission to the Standing Committee on Economics inquiry into tax deductibility**

### **Business Deductions**

#### **Interest deductions in the international framework**

1. As outlined in Treasury's 18 January 2016 submission, Australia has integrity rules, which include comprehensive thin capitalisation rules and transfer pricing rules, to address concerns that may arise from interest deductions derived from international transactions.

#### **Thin capitalisation**

2. Treasury is continuing to monitor the impact of the changes made to the thin capitalisation rules in 2014, as well as the final Organisation for Economic Co-operation and Development (OECD)/G20 recommendations addressing Base Erosion and Profit Shifting (BEPS) (BEPS Action 4, limitation of interest deductions).

#### **Transfer pricing**

3. On 9 February 2017, the Government introduced legislation into Parliament, through the Treasury Laws Amendment (Combating Multinational Tax Avoidance) Bill 2017, to update Australia's transfer pricing rules to reference the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) as amended by the BEPS Actions 8-10 (transfer pricing and value creation) recommendations. The update applies from income years commencing on or after 1 July 2016.
4. Incorporation of the OECD Guidelines update will, amongst other things, ensure the pricing of transactions reflects the economic substance of the transaction rather than just the contractual form. For example, it will ensure the interest rates attributed to related party loans reflect the actual commercial risks assumed.

#### **Hybrid mismatch rules**

5. Countries each have sovereignty over their own tax policy. This may result in their making what turns out to be different tax policy choices, including how financial instruments and entities are characterised. Specifically, financial instruments may be treated as debt or equity, financial transactions treated as a sale or a loan, and entities characterised as opaque or transparent.
6. Such differences can create a mismatch in tax outcomes that allow multinationals to avoid paying relevant taxes in any jurisdiction or to defer paying tax for long periods. For example, for a single payment, multinationals could obtain interest deductions in different countries or an interest deduction in one country without a corresponding amount of income being included in assessable income in the recipient country.
7. In the 2016-17 Budget, the Government announced that it will implement the OECD's recommendations to neutralise such tax mismatch outcomes (BEPS Action 2, neutralise hybrid mismatches). The measure will apply from the later of 1 January 2018 or six months following the date of Royal Assent of the enabling legislation.

8. Under the new rules to neutralise hybrid mismatch outcomes, Australia will deny a tax deduction if the offshore related party receiving the payment is not taxed on the income. Similarly, if a tax deduction is not denied to an offshore related party in relation to a payment to an Australian entity which would otherwise not be taxed in Australia, the income received in Australia will be taxed.

## Measures that simplify compliance

### Regulatory System Renewal

9. The 2016-17 Budget included a measure for Treasury's implementation of the Government's strengthened Regulatory Reform Agenda, through a Regulatory System Renewal (RSR) programme. The RSR programme is a coordinated approach to regulatory reform delivered through a rolling series of reviews of regulatory frameworks.
10. A number of inquiries on various topics have identified barriers to innovation, competitiveness and productivity imposed by the design and effect of various regulatory regimes or disparate approaches. Government responses to those inquiries have generally accepted the principle of reviewing regulatory frameworks to identify and eliminate these barriers.
11. Treasury's stock of regulation has been estimated to impose \$47 billion of annual compliance costs. There are reform opportunities.
12. The initial focus of the Regulatory System Renewal programme will be on the tax law, issues identified in the Competition Policy Review, and other processes, including Government responses to Productivity Commission reports.

## Personal deductions

### Occupational clothing and related tax deductions

13. The Government is reviewing the rules and regulatory requirements in Division 34 of the *Income Tax Assessment Act 1997* which deals with tax deductions for non-compulsory uniforms. The review is considering whether the current arrangements remain fit-for-purpose, necessary and relevant and alternative options.
14. The *Review of the Register of Approved Occupational Clothing and related tax deductions* discussion paper was released on 18 November 2016 and consultations closed on 16 December 2016.
15. The Government is currently considering its response to the submissions made to the review.

## International comparisons

### Investment expenses

16. Treasury's submission to the inquiry indicated that negative gearing was available in Australia but relatively more limited in Canada (table 4). With further investigation it now appears that the negative gearing regime in Canada may in fact be more closely aligned with that of Australia than earlier thought.