Note on 2014 Amendment to Australian Participation Exemption for Dividends

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Following the hearing of the Senate Committee conducting the Inquiry into Corporate Tax Avoidance and Aggressive Minimisation on 8 April 2015, some senators requested an elaboration of the 2014 change to Australia's tax law which seems to run counter to one aspect of the G20/OECD BEPS project.

The amendment concerns the repeal of section 23AJ of the Income Tax Assessment Act 1936 and its replacement with section 768-5 of the Income Tax Assessment Act 1997 made by Tax and Superannuation Laws Amendment (2014 Measures No 4) Act 2014 Schedule 2 items 1 & 4. In broad terms both sections exempt from Australian income tax distributions (dividends) received by Australian resident companies from their foreign subsidiaries. Apart from a brief period 1987-1990 Australia has had an exemption of this kind in domestic law since it started taxing residents on a worldwide basis in 1930.

Prior to the change the exemption was limited to dividends on legal form shares in companies. Concern was expressed that this permitted the exemption to be claimed on shares which had many of the characteristics of loans (typically redeemable preference shares). The Board of Taxation in the course of its enquiries on taxation of foreign source income made recommendations for change and these were taken up by the Labor government but never enacted while it was in power. When the current government made decisions about the backlog of unenacted tax legislation in 2013 it decided to proceed with this change, see http://axs.ministers.treasury.gov.au/media-release/003-2013/ item 19, second bullet point.

The way the change was enacted is to substitute the equity test in Australia's debt-equity rules for the previous legal form shares test. This means that interest paid on loan instruments that are classified as equity under Australia's debt equity rules (a classification which is very easy for taxpayers to arrange) will qualify for the exemption where it would not previously have qualified. Because most countries in the world (but not all of them) follow a legal form approach to characterising instruments as debt or equity, the change enables a hybrid mismatch arrangement of the kind designed to be prevented by Action 2 of the OECD BEPS Action Plan (that is, the country of the payer of the interest treats it as interest and allows a tax deduction while Australia exempts it under section 768-5, producing double non-taxation).

It is possible to produce such hybrid mismatches with redeemable preference shares (in outbound dividend situations) but the 2014 change has now facilitated them in inbound situations without fixing the outbound case. To eliminate the hybrid mismatch fully under domestic law in inbound cases it would be necessary to deny the Australian exemption if the payment is deductible in the other country, which is what the EU has recently done through amendments to its Parent-Subsidiary Directive and is recommended by the OECD in its work on Action 2.