It is now apparent that multinational tax avoidance and aggressive tax planning is a significant fiscal risk to the country.

We have already seen major amendments to Australia's tax regime to tackle base erosion and profit shifting (BEPS). Several more significant measures were announced in the federal budget, most notably the diverted profits tax, aimed at multinationals which shift tax to a lower taxing jurisdiction.

Yet to date, a very simple tax minimisation strategy has been largely ignored in the ongoing reforms and was ignored in the federal budget.

Excessive debt loading is a problem that not been afforded the same attention as other aggressive tax planning strategies adopted by multinationals. Nevertheless, excessive debt loading is a very simple technique used by multinational entities to reduce their overall tax liability. And, it is recognised as a global problem. Another term for excessive debt loading is thin capitalisation.

Money is mobile so a multinational can simply shift debt into high tax counties to ensure that a tax deduction is received for the interest paid. This reduces the overall profits in the high tax country, thereby reducing their tax liability. In Australia's case, the entity loads up their Australian operations with tax-deductible debt.

Excessive debt loading was highlighted as an aggressive tax practice by the Senate Inquiry into Corporate Tax Avoidance. In part two of its report, handed down on 22 April 2016, the Senate Inquiry highlighted the fact that debt-related deductions span a number of related areas including thin capitalisation and transfer pricing. They also emphasised the difficulty in finding publicly available "real life" examples.

The OECD has also recognised that the ability of multinationals to adjust the amount of debt to achieve favourable tax results is a serious global problem. The report on Action Item 4 of the OECD/G20 BEPS program specifically addresses the BEPS risk arising from three different

types of strategies:

- Groups placing higher levels of third part debt in high tax countries

- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense

- Groups using third party or intragroup financing to fund the generation of tax exempt income

Australia already has a thin capitalisation regime designed to tackle this sort of behaviour. Thin capitalisation rules have existed in Australia since 1987. The current regime, introduced in 2001 and found in Division 820 of the Income Tax Assessment Act 1997, is designed to prevent multinationals from claiming excessive debt deductions to reduce their Australian taxable income.

The rules operate by disallowing a proportion of the otherwise deductible interest expense where the debt allocated to Australia exceeds certain limits. The limits are determined by reference to what is known as the "safe harbour" debt amount, an "arm's length" debt amount, and a "worldwide gearing" debt amount. However, the problem of excessive debt loading still exists.

Of particular interest is the safe harbour debt amount generally referred to as the allowable debt to equity ratio. Prior to the budget there was a suggestion that Australia's thin capitalisation rules would be tightened for the second time in as many years with an adjustment to the ratio. However, instead reform proposals centred around the diverted profits tax and "anti-hybrid" rules, with thin capitalisation ignored.

When the OECD's final report on BEPS was released last October, Treasurer Scott Morrison indicated in a media release that Australia had already tightened its thin capitalisation rules and intimated that no further changes would be made. Clearly, the Federal Government is again sending a message that it does not see any problems with the current regime.

However, Australia is not moving towards the OECD's suggested "best practice" approach. The Federal Government seems to be at pains to ensure the OECD leaves it alone when it comes to thin capitalisation rules.

No one doubts that thin capitalisation rules require a balance between maintaining the integrity of the tax base, or preventing BEPS, and not impeding the efficient allocation of capital. The OECD however points out that there is evidence that excessive debt loading is a serious problem to the erosion of the tax base. It provides a model which it argues is best practice for domestic law. The ratio aspect of the OECD recommendation is similar to Australia, but the approach is not.

Australia's current approach relies on a ratio of debt to equity. The OECD BEPS recommendation is a fixed ratio rule but one that is a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). It then recommends a ratio of between 10-30%. Alongside the fixed ratio, the OECD recommends a group ratio rule.

There is an argument that Australia's current regime is relatively close to the common approach suggested by the OECD. There is a ratio test, albeit based on different factors. There is also a worldwide gearing option similar to the OECD's group ratio rule. However, the different ratio approach can make a significant difference. Australia links its ratio to debt and equity of the entity, an approach that the OECD argues is easy to manipulate. The OECDs model links its ratio to interest and earnings. This approach is aimed at ensuring that net interest deductions are directly linked to the taxable income generated by its economic activities.

The OECD proposals are designed to ensure that profits are taxed where the underlying economic activity occurs and where value is created. We need to ask ourselves whether a thin capitalisation regime that focuses on debt, equity and assets achieves this goal. Perhaps this is a forgotten means of aggressive tax planning that needs to be explored and also targeted for reform.

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Read more http://theconversation.com/thin-capitalisation-the-multinational-tax-avoidance-strategy-the-budget-forgot-58041