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Review of Thin Capitalisation Arm's Length Debt Test
The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Sir or Madam

SUBJECT: SUBMISSION ON DISCUSSION PAPER IN RELATION TO THE REVIEW OF THE THIN CAPITALISATION ARM'S LENGTH DEBT TEST

CPA Australia represents the diverse interests of more than 150,000 finance, accounting and business professionals in 121 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders.

Against this background we provide this submission concerning the Board of Taxation Discussion Paper entitled 'Review of the thin capitalisation arm's length debt test' which issued on 16 December 2013.

CPA Australia welcomes the Board of Taxation's review of the Arm's Length Debt Test (ALDT) available under the thin capitalisation provisions of Division 820 of the Income Tax Assessment Act (1997) (the ITAA (1997)).

In our view many in-bound and outbound taxpayers must resort to the ALDT as their gearing levels will necessarily exceed the safe harbour maximum allowable debt tests otherwise available especially if the safe harbour debt to equity ratio is reduced from a 3:1 to a 1.5:1 ratio for income years commencing on or after 1 July 2014 as currently proposed.

We note that this view may prima facie appear contrary to our submission to the Business Tax Working Group dated 20 September 2012 in which we canvassed the removal of the ALDT as one of several initiatives which could be applied to potentially fund a corporate tax rate cut.

However, we only advocated such a measure on the basis that the savings applied from the repeal of the ALDT and other tax concessions were used to realise CPA Australia's long advocated reform to materially cut the corporate tax rate to boost productivity and make Australia more internationally competitive.

Accordingly, in the absence of such corporate tax relief we believe that the ALDT should be retained to ensure those entities commercially compelled to operate on gearing ratios which exceed the proposed 1.5:1 safe harbour test are able to fully claim eligible debt deductions provided that their borrowings reflect the level of debt taxpayers could borrow in the open market on an arm's length basis in respect of their Australian operations.

General comments

We make the following general comments concerning the retention and application of the ALDT:

- We believe that the ALDT should be retained as many taxpayers must borrow debt in excess of the proposed 1.5:1 debt to equity safe harbour ratio in order to remain viable.

We understand that this will include many utility or power generation entities who have been previously required to fund their operations using significant third party debt from lenders who have regarded such funding as a relatively low risk investment.

However, access to the ALDT is also essential where an entity has a low level of net assets and thus will as a corollary have a relatively low safe harbour maximum allowable debt. For example, an information technology company which has established a valuable internet product may also have a low level of assets as its principal asset is often unbooked intellectual property or goodwill, (and it does not usually hold material real property or fixed assets). Accordingly, the actual funding of such entities needs to be based on their total operations and not just the net assets shown on their balance sheet. As Australia wants its share of growth in the new digital economy the retention of a robust ALDT can assist such entities to obtain required funding without putting the revenue unduly at risk.

Similarly, some entities will also require significant long-term debt funding to finance large scale construction or infrastructure projects especially in the early years of such projects where typically there is no income being derived and assets are only being gradually built or completed. In these circumstances the proposed 60 per cent safe harbour ratio may give some businesses insufficient deductible debt to finance much required capital works especially substantial infrastructure projects which are crucial if Australian business is to become more cost efficient.

Accordingly, we believe that the ALDT should not be removed but that its design features should be amended so that it more correctly reflects the application of the arm's length principle to the amount of debt that a taxpayer could potentially borrow in respect of its Australian business activities. This will become more critical upon the proposed cut to the 60 per cent safe harbour debt to equity ratio which is scheduled to apply from 1 July 2014 onwards;

- Consistent with our long-term policy position on maintaining broadly based tax concessions we believe that potential eligibility to apply the ALDT should not be limited to specific industries but should instead be available to all inbound and outbound taxpayers who are not otherwise exempted from the thin capitalisation provisions under Division 820 of the ITAA (1997) to the extent their Australian operations are funded by debt. For the reasons detailed above we do not believe that it is prudent to limit the scope of the ALDT to prescribed specific industries as there may be an array of varying circumstances in which a taxpayer could justify their borrowings as being on a demonstrably arm's length basis which exceeds the safe harbour maximum allowable debt limits;
- We acknowledge the complexity of the current ALDT and the related costs incurred by taxpayers in complying with the test and by the ATO in administering it. However, we believe that some of the current complexity could be addressed if the primary test to satisfy under the ALDT was limited to the commercial lender test being the amount that an entity could potentially borrow from a commercial lending institution on an arm's length basis. Where this amount is determined it would then be necessary to confirm that the borrower subsequently applied such borrowings for appropriate commercial purposes. Such an approach is attractive as it is broadly congruent with the operation of the recently amended transfer pricing provisions under Subdivision 815-B of the ITAA (1997) in determining appropriate arm's length interest rates on debt. It also eliminates the complexity associated with the current borrower test which is inherently subjective in nature; and
- Much of the current complexity and related compliance and administration costs also stem from the need to retrospectively test compliance with the ALDT. This approach is not aligned to typical commercial funding arrangements where debt instruments issued generally have a term of between three and five years rather than for a single year. We believe that there is considerable merit in exploring the option of introducing Advanced Thin Capitalisation Agreements (ATCA) so that the terms of a medium to long-term debt funding facility which is compliant with the ALDT can be mutually agreed by both taxpayers and the Australian Taxation Office (ATO) for the term of such a borrowing. Hence, where the parties enter into an ATCA there will only be a need for both the taxpayer and the ATO to monitor any material changes to the relevant facility which would otherwise remain in place and provide certainty to all parties as to an entity's maximum allowable debt under the ALDT for the agreed term. We broadly understand that such an approach is applied in the United Kingdom under its thin capitalisation regime and its adoption locally would also be consistent with the Advanced Pricing Arrangements regime applied by the ATO in respect of transfer pricing compliance.

Specific comments

We also make the following specific comments in respect of the Discussion Paper:

- We do not support the proposal that additional safe harbour tests based on earnings should be incorporated into the ALDT as we are concerned that there could be too much variance in earnings metrics between different industries for any generalised safe harbour tests to be reliably developed. Accordingly, we believe that the application of the arm's length principle in itself will be sufficiently robust especially given the need for taxpayers to more generally understand, apply and document this principle following the enactment of Subdivision 815-B; and
- A key technical issue to address in any review of the ALDT is to remove the requirement that the arm's length test be applied based on the factual assumption that credit support (including guarantees) should be ignored under the ALDT. We believe that many third party lenders would in practice require some form of an express guarantee from the offshore parent of a foreign owned entity prior to making any funding available to the Australian subsidiary. However, we believe that in the bulk of cases an arm's length amount could be attributed to the Australian entity for the value of the guarantee applying the arm's length principle which could be included in its assessable income and thus be recognised in the application of the ALDT. Alternatively, further guidance on the practical application of this requirement would assist taxpayers to determine their maximum allowable debt under the ALDT as it is a common stumbling block in currently applying the test.

If you have any questions regarding the above, please contact Mark Morris, Senior Tax Counsel, on (03) 9606 9860 or via email at mark.morris@cpaaustralia.com.au.

Yours faithfully



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