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The Board of Taxation
c/- The Treasury
Langton Crescent
CANBERRA ACT 2600

17 March 2014

Dear Sir / Madam

Re: Review of the Thin Capitalisation Arm's Length Debt Test

Deloitte welcomes the opportunity to provide comments to the Board of Taxation for purposes of the Review of the Thin Capitalisation Arm's Length Debt Test (ALDT).

We provide below:

1. The case for retaining the ALDT for all industries
2. Suggestions for improvements to the ALDT legislative provisions
3. Suggestions for improvements in application and administration of the ALDT including:
   (i) Improve / supplement existing guidance
   (ii) Introduction of an advance rulings program.

In Appendix 1 to this letter we provide specific responses to various Questions raised by the Board of Taxation in its paper. We also provide for the Board of Taxation's reference in Appendix 2 some context to the historic relative lack of guidance by the OECD in this area.

1. The case for retaining the ALDT for all industries

The ALDT is an important part of Australia's thin capitalisation regime to recognise that certain taxpayers and industries do as a matter of commercial reality operate on gearing ratios greater than the 3:1 (Debt:Equity) safe harbour.

It is relevant that at the time the policy was being developed, many previously state owned utilities (power generation and distribution, airports, roads, rail) were being privatised, and being heavily regulated and

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monopolistic were seen as low risk investments by the market. It seems that the ALDT legal framework and much of the ATO guidance were developed with such cases in mind.

The ALDT is, however, an important optional test for other types of taxpayers otherwise disadvantaged by the safe harbour, such as those with all (or predominately all) third party debt, companies holding low levels of on-balance sheet assets, and those in need of significant longer term project finance during the development phase of a major capital project. We note that Australia's thin capitalisation rules consider both related and third party debt, further making the ALDT a necessity.

It is therefore considered both inequitable and administratively impractical to limit the test to certain industries.

The need for the ALDT is heightened given the proposed reductions of the thin capitalisation safe harbours, which will mean more taxpayers that could (or have) borrowed debt in the open market in excess of the safe harbour calculated amount (or worldwide gearing level) will need to rely on the test to ensure their genuine interest expenses are deductible for tax purposes.

Given the likely increased adoption of the test, we welcome the Board's review of the test with a view to improving its efficacy.

2. Improving the ALDT legislation

The current legislation relating to the ALDT (at sections 820-105 and 820-215 of the ITAA 1997) is somewhat cumbersome and its drafting could be improved in a number of ways (as set out below). Notwithstanding this, we believe that significant gains in terms of improvement in making the test easier to apply (for taxpayers) and administer (for the ATO), can also be made in a rewrite of the guidance currently set out in TR 2003/1, or development of supplementary guidance.

Specific legislative improvements could include providing:

- Clarity on what is meant by the factual assumption to ignore credit support provided by associates, and specifically whether an arm's length price for that credit support (assuming it could be obtained in the market) sufficiently deals with this assumption
- Clarity whether the income streams (including dividends) received from, and related expenses paid to, overseas subsidiaries can be taken into account for the test. In addition, whether assets such as cash assets arising from accumulated dividends received are taken into account in defining the tested entity. A true arm's length test (such as that applied in the UK) would include overseas assets/subsidiaries of the entity, as any third party financier would have regard to such assets/income. As such, the current ALDT should be recognised to be a constrained arm's length test, having defined the entity per the factual assumptions
- Clarity that although the test is an annual test for a particular tax return, it is acceptable to consider a longer term framework when applying the test in situations where the debt finance is medium/long term and the usage of the funds to finance term investments/uses

- Simplification of the test including alignment of the 'independent borrower' test to a qualitative test focusing on the commercial basis for the borrowing(s) having regard to the options realistically available to the borrower
- Simplification of the list of relevant factors to be both more generic and relevant to the practical application of the test
- A change to the mechanism of the test from a requirement to determine an arm's length debt amount, to allowing the confirmation that the actual amount of debt is at a level which could occur between third parties in the market. It is often very difficult in practice to determine the maximum amount of debt, requiring stress testing of ratios and additional analysis that does not seem to add any additional value.

3. Achieving improvements in application and administration of the ALDT

In the absence of legislative changes, much improvement in applying and administering the ALDT can be achieved through a collaborative 'co-design' process between industry, practitioners and the ATO to:

- Improve and redesign the guidance on application of the test including more targeted and detailed guidance on how to approach the key comparability / benchmarking issue (i.e., rewrite TR 2003/1), and

- Introduce a workable Advance Pricing Arrangement (APA)/Advance Thin Capitalisation Agreement (ATCA) regime modelled on the UK's regime to provide certainty to taxpayers in an inherently uncertain area, and reduce the need for costly ATO audits/inquiries, improve ATO capability in this area and to provide the market with direction on what is considered acceptable by the ATO (e.g. analytical approaches, key ratios, typical benchmarks by industry).

(i) Improve / supplement existing guidance

The guidance on application of the ALDT, as expressed in the Taxation Ruling 2003/1 can be improved to assist both taxpayers in applying the test and the ATO in administering the test. Such improvement could also take the form of provision of supplementary guidance on specific aspects of the test, perhaps in the form of an ATO practice statement. From a practitioner's perspective, the guidance does not fully reflect how the ALDT is applied by the taxpayers (based on third party lending practices) and its prescriptive nature makes it difficult to adapt to cases where industry specific practice differs from the guidance.

In particular, the guidance regarding the ATO defined 'Step 4' (independent borrower test) and 'Step 5' (independent lender test) could be improved. The key areas where the guidance could be revised include:

- The prescriptive nature of the current guidance makes its application to certain industries problematic. The ALDT is aiming to replicate independent lending practices, which can differ significantly between industries. For example, Taxation Ruling 2003/1 mentions the use of specific ratios (such as annual Debt/EBITDA[1], EBIT[2] interest cover ratios), which may be inconsistent with lending practices in some industries. Taking a practical example to illustrate this point, in large capital projects, the early years of the debt arrangements are commonly characterised by negative cash flows and losses through the

[1] Earnings Before Interest, Tax, Depreciation and Amortisation
[2] Earnings Before Interest and Tax

construction period. The guidance would better suit the needs of taxpayers and the ATO if it focused on the key principles. The inclusion of specific case studies would also be beneficial, for example considering:

(i) a business services company (with few tangible assets)
(ii) a utility company, with long term and secure purchase and supply contracts
(iii) a company undertaking a major capital project with a construction and operating period.

Such an approach has the advantages of improving guidance without the introduction of supplementary safe harbour ratios, which will be very difficult to define for the reasons set out above.

- The borrower analysis requires determination of the amount that the borrower would reasonably be expected to have borrowed, which is an inherently subjective question. Taxation Ruling 2003/1 comments that there may be an overlap in the independent borrower and lender tests, but does not acknowledge that the practically unknowable financial risk appetite of the borrower means the independent borrower analysis is particularly subjective. In our view, the core analysis of the ALDT should focus on the independent lender test (to be performed first), while the borrower test should be focused on a qualitative analysis focusing on the commercial basis for the borrowing(s).
- Consideration of how to approach lender's risk appetite would be helpful, including for example how to approach the issue of high risk lenders, and whether such lending approaches can be considered as part of the test
- Clarification from a practical perspective of the ATO approach to some of the key deficiencies of the current legislation which create uncertainty (see comments section above). This could include treatment of associate entity credit support (explicit and implicit), treatment of income streams from associate entities including subsidiaries of the Australian taxpayer, and how to treat long term debt arrangements that cross over multiple tax years.
- When all (or substantially all) of the debt under review has been borrowed from third parties, a simplified approach should be promoted. If the borrowing is for the purposes of an Australian business (as defined in legislation) and there is no parental/ group credit support and/ or guarantees, the full amount of third party debt should be allowable.

(ii) Introduction of an Advance Rulings Program

The ALDT is a subjective test considering market practices for given factual situations, and as such is subject to uncertainty. Taxpayers value certainty in managing their tax and reducing exposure to risk. Certainty in tax affairs helps to reduce costs by eliminating the possibility of disputes with the ATO and reducing the need for setting aside reserves to offset potential tax liabilities against uncertain tax positions.

As such, taxpayers will welcome the introduction of a specific programme, similar to the ATO's APA programme, or UK's ATCAs dealing specifically with capital structures and related issues. This is regarded as a program that works well, with the average ATCA completion period reported by HMRC to be 10 months.

Such a program would provide the opportunity to improve ATO capability in this area and to provide the market (i.e., taxpayers) with direction on what is considered acceptable by the ATO (e.g. analytical approaches, key ratios, typical benchmarks by industry). This would particularly be the case if the program

were accompanied by transparent publishing of sample agreements, much like the HMRC's approach in the UK.

Appendix 1 provides responses to some of the specific questions raised by the Board of Taxation, having regard to the above summary principles. **Appendix 2** provides some contextual commentary to the OECD's position on this issue to date.

Deloitte would be pleased to meet with you to further discuss our views and/or participate in consultation forums. In addition, Deloitte would be pleased to work with the ATO and relevant stakeholders in a co-design process to develop the improved / supplementary guidance referred to above.

Yours sincerely

Geoffrey Gill
Director
Deloitte Tax Services Pty Ltd

Appendix 1

1 Specific questions: Chapter 4

1.1 Section 4.1

(a) *whether the test should only be applied in the year in which the borrowing takes place (and be deemed to continue to be available until the earlier of five years or if there are material changes to the loan) and what criteria could be used for determining material changes;*

(b) *whether the factual assumptions and relevant factors could be reviewed so that they are prospectively focussed rather than retrospectively to better reflect the relevant economic conditions affecting the Australian operations;*

(c) *whether removing the requirement to apply the ALDT annually and replacing it with an initial requirement to apply the test at the time of borrowing, subject to a required reassessment when there is a material change, could assist in remedying its retrospective focus;*

- Application of the test in the year of borrowing draw-down having regard to forecast data and with inclusion of specific covenants would generally be consistent with commercial lending practices. Such an approach by the taxpayer would reduce the later annual testing to confirmation around meeting specific covenants. This approach would be best applied where an Advance Ruling is put in place with the ATO and would reduce the compliance burden (and ATO monitoring burden) materially. Indeed such a ruling based approach could go further and define the amount of allowable debt in each year based on defined metrics set in advance.

- In the absence of a ruling, it is difficult to see how the removal of a requirement to have an annual test could be applied on a self-assessment basis, although clearly the taxpayer can (within the scope of the current ALDT regime) elect to limit the repetition of work and simply focus on material changes in situations such as this. As noted above, additional guidance, such as through illustrative examples of an application process would help taxpayers understand how to approach these prospective / retrospective aspects of the test. It is not possible to be prescriptive on what would constitute a material change, as it will depend on the taxpayer's circumstances.

(d) *the advantages and disadvantages of introducing additional safe harbour tests based on earnings, what financial ratios may be considered as additional safe harbour tests for determining the arm's length debt amount and whether international experience could assist in improving the ALDT;*

- It is very difficult to come up with and agree on particular ratios which will be suitable for a wide range of industries. More specific ratios for each industry will result in uncertainty as to which industry a taxpayer relates to. We would propose that better guidance by way of case study examples would assist in illustrating the process of analysis required and achieve much of what a safe harbour would seek to achieve with much less complexity and controversy.

- In the real world credit conditions change over the economic cycle, meaning ability to obtain credit for a given set of assets/earnings, changes over the cycle.

- A set of additional optional safe harbours for the ALDT has the potential to create another safe harbour thin capitalisation test, potentially resulting in confusion.

(e) *whether there is scope for the potential simplification of the ALDT when there is no related party debt; whether the concept of 'related party debt' would require any additional clarification for these purposes; if so, what issues would need to be clarified and what integrity concerns would need to be addressed in those circumstances;*

- As noted above, better guidance on this aspect of the test would be welcomed, in particular setting out that subject to any modifications that may be required for the factual assumptions (e.g. associate entity credit support). Where all the debt is provided by arm's length parties and relates to an Australian business, the ALDT should be satisfied. We discuss the issue of implicit credit support below.

(f) *whether credit support from related parties could be recognised in particular circumstances when they correspond to ordinary commercial dealings and do not represent integrity concerns, and how to determine those circumstances;*

- Guidance needs to be more specific on how to deal with credit support/ guarantees. In certain circumstances it is commercial practice for lenders to only extend funds where guarantees are in place (for example certain project financing arrangements with substantial completion risks). Arm's length pricing of such guarantees following generally accepted transfer pricing approaches, deals with the issue by ensuring the Australian taxpayer 'pays' for such support, and any ALDT ratio calculations and benchmarking are performed net of such support. This would mean associate entity guarantees and non-associate entity guarantee arrangements are placed on a level playing field.

- Implicit credit support is more challenging, particularly in situations where third party banks might place some weight to such support in making lending decisions. This is because such support is considered non-chargeable under Para 7.13 of the 2010 OECD Guidelines, meaning imputation of any charge, such as that suggested for explicit guarantees / security, would be in contravention of the Guidelines. Practically, outside of the financial services sector, this issue is likely to be fairly rare, however it seems the only logical answer given the current framework of the ALDT is to assume the entity is independent of the MNC (i.e., does not receive any implicit support), and apply relevant metrics.

(g) *the facilitation of advance thin capitalisation agreements similar to those applying in the UK;*

- The Advance Thin Capitalisation Agreement (ATCA) regime in the UK is well established with 144 ATCAs agreed in 2012/2013[3] and 414 ATCAs in force during the year.
- According to our Deloitte UK colleagues, the ATCA system works effectively and is used by taxpayers who value certainty.
- We understand that ATCAs are handled by transfer pricing specialists within HMRC, rather than a dedicated ATCA team. Achieving resolution is swift with 50% of ATCAs being agreed in under 10 months
- We note that the HMRC website contains a model ATCA agreement which sets out terms of the ATCA, as well as contains suggested financial conditions (i.e. target profit based ratios).
- ATCAs form part of UK APA regime and concentrate on various aspects of debt capital, including interaction of transfer pricing and other relevant tax issues that arise (e.g. withholding tax as required)
- As set out above, we endorse the introduction of an effective ATCA or APA regime in Australia and consider there is significant upside for both the ATO and taxpayers from the adoption of such a regime in an area where there is inherent uncertainty (at least, and perhaps more so, than many other 'transfer pricing' issues). Australian ATCAs would work to apply the Australian arm's length debt test as defined by the relevant legislation.

(h) *whether there is a need to provide further legislative or administrative guidance regarding the exemption from the thin capitalisation rules for certain special purpose entities; and*

- Further guidance on the application of the ALDT where associate entities are exempt from the thin capitalisation rules (e.g. securitisation vehicles) would be of assistance, particularly where finance is lent on back-to-back terms to the entity subject to thin capitalisation rules.

(i) *any other suggestions stakeholders may have drawing on experiences from other countries, for example, Canada, that would assist in reducing compliance costs while at the same time preserving the integrity of the thin capitalisation rules.*

1.2 Section 4.2

(a) *whether it is practical to apply separate borrower and lender tests and, if not, how this could be simplified while retaining the integrity of the rules ;*

(b) *whether in practice a distinction is made between the amount that an entity 'would' reasonably be expected to borrow and the amount the entity 'could' reasonably be expected to borrow and how this distinction is made. If no such distinction is able to be made, what are the implications for the ALDT analysis;*

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[3] HMRC website, Transfer Pricing Statistics

(c) *whether there is a clear distinction between the 'would' versus the 'could' element based on international experience in complying with the United Kingdom thin capitalisation rules and, if so, how its design could assist in improving the ALDT;*

- There are some differences between the 'would' and 'could' elements, and these can be analysed separately. However, based on the current guidelines there is a large degree of overlap that leads to potential duplication.
- We understand that the UK ATCA experience shows that dealing with 'would' argument is difficult as taxpayers' appetite for financial risk is essentially unknowable and unobservable. As such, we understand that HMRC does not ordinarily seek to define the 'would' element
- It would be preferable that the independent lender test is the primary test and the independent borrower test is read down to focus on the qualitative analysis of the commercial rationale for borrowing, including relevant financial metrics.

(d) *whether the [objective/subjective] assessment of the ALDT can be improved and, if that is the case, how its design could be improved to achieve its intended outcome;*

(e) *what are the relevant factors and/or assumptions an independent lender would take into account when assessing the creditworthiness of an entity, for example, would an independent lender consider the impact of intangibles (as well as internally generated goodwill not included in the balance sheet) and other financial factors (such as implied or explicit credit support) relating to the entity;*

- The presence of off balance sheet assets for some entities which lenders would have regard to, demonstrates the need for an ALDT test that does not distinguish by industry and is principle based. It would be normal for lending to have regard to sustainable earnings from such assets represented by interest cover, Debt:EBITDA and potentially other ratios.

(f) *whether there are compliance costs and uncertainties involved in the required identification of the relevant Australian business and, if so, how they could be alleviated without compromising the integrity of the rules;*

- In some situations, this can add complexity to the test, however it is likely a necessary aspect of the test.

(g) *whether there is a need to better define and provide guidance on the identification and exclusion of certain types of credit support to avoid inappropriate outcomes and, if so, how this could be achieved;*

- See discussion above. Guidance is required on how the taxpayers can hypothesise alternative steps that can be taken when there is no charge for a guarantee / credit support that has a value, for example by hypothesising and pricing the third party guarantees or credit support arrangements

(h) *whether there is a need to provide further legislative and administrative guidance to assist the use of benchmarking analysis and, if so, what are the priority areas; and*

- Better administrative guidance explaining in more detail how to apply the test, and distinguishing between different industries by way of case study examples would be preferred. Such guidance would show the typical ratios considered by lenders such as interest coverage, Debt:EBITDA, and loan to value ratios (for property). Another priority area would be the approach to long term financing arrangements for capital projects involving construction and operating periods.

(i) *any other issues faced by stakeholders in applying the required factual assumptions and relevant factors where compliance could be facilitated, and how.*

2 Specific questions: CHAPTER 5 and 6

Please see our comments set out in the letter above which address many of these questions.

- Any Advance Rulings Programme, when introduced, should be voluntary to the taxpayer.

Appendix 2 - Context to OECD position on arm's length capital structure

The arm's length debt test is premised on the assumption that the arm's length principle applies to the capital structuring or gearing of a subsidiary, at least to set the upper bound on acceptable debt levels. This assumption is widely understood to be based on comments in Chapter 1 of the OECD Transfer Pricing Guidelines. The position in Chapter 1 is that a tax authority may substitute debt for equity where there is related party debt and the debt is seen as excessive. However, although this statement has always appeared in Chapter 1, the OECD has never given any guidance in the subsequent 35 years as to how to apply the arm's length principle to the question of gearing.

The only work by the OECD on capital structuring is found in the Authorised OECD Approach (AOA) to the attribution of profits to PEs under Article 7 i.e. the attribution of capital within a single legal entity. That work recognises two methods of arm's length attribution of capital; the "thin cap" approach used by the UK (the independent lender/independent borrower method) and the risk weighted asset attribution approach for banks (Basel method). It also accepts safe harbour approaches such as Australia, as long as they do not attribute excessive capital to the PE.

So for purposes of Article 7 the OECD recognises the 'thin cap approach' which is essentially the ALDT in Australian domestic law. However, we understand that an attempt by the OECD to provide further guidance on cross border financial transactions, including thin capitalisation issues, under the Transfer Pricing Guidelines for Article 9 had to be deferred when it became apparent that a number (sizable minority) of countries did not accept the arm's length principle could or should be applied to questions of capitalisation of subsidiaries.

We understand that the position taken by those countries at the time was that the position in Chapter 1 simply allows countries with domestic thin cap regimes to have those regimes and not be in contravention of the treaty. From a policy perspective, they argued, thin capitalisation should be dealt with under domestic anti-abuse rules and not by way of the arm's length principle. Many countries also rejected the acceptance of the "thin cap" method for Article 7 but given the AOA allows for alternative approaches, this enabled the work to be finalised.

It is understood that the OECD is revisiting the issue of cross border debt transactions to seek to provide further guidance under the Transfer Pricing Guidelines so it is possible this issue will again arise on the global stage. In addition, Action Point 4 of the OECD Base Erosion and Profit Shifting Action Plan which deal with '*Limiting base erosion via interest deductions and other financial payments*', may result in further guidance in the area.