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Review of the thin capitalisation arm's length debt test
EY submission in response to December 2013 discussion paper

To the Board

EY is pleased to respond to the Board of Taxation's (the Board's) discussion paper 'Review of the thin capitalisation arm's length debt test' (the paper) released for consultation on 16 December 2013.

We welcome the review and support the objectives of its terms of reference, to examine ways to make the arm's length debt test (ALDT) more effective including by reducing compliance costs for business and making it easier for the ATO to administer, while still maintaining the underlying policy of the thin capitalisation rules.

In the attached Appendix we have outlined our key submission points which reflect our extensive experience in the consideration of the thin capitalisation rules across a wide range of industries and specific taxpayers. In summary, our key submission points are:

1. The ALDT must remain an available option for all taxpayers. There are a wide variety of taxpayers across a wide variety of industries where the ALDT might reasonably provide for a maximum allowable debt level that is higher than the statutory safe harbor, without being excessive or disproportionate on an arm's length basis. For this reason we strongly submit that the ability to access the ALDT should not be limited to any prescribed industries or class of taxpayer.

2. The ALDT needs to remain flexible in its application. By definition, the ALDT requires an evaluation of factors peculiar to a particular taxpayer and, as such, should not have its application constrained by the introduction of prescriptive formulas or other limiting mechanisms. In particular, it should be clear that the accounting rules around recognition and valuation of assets that are applicable in calculating the maximum debt levels using the balance sheet based safe harbor test are not be relevant to the application of the ALDT.

3. We support the creation of a second and alternate safe harbor test based on a set percentage of an entity's 'EBITDA'. This test should not be in substitution for the existing balance sheet based safe harbor test (nor the ALDT) but would be a low compliance alternative for certain taxpayers who have sufficient cash flows based on EBITDA to support higher gearing levels than the current balance sheet safe harbour approach allows. An appropriate (to both taxpayers and the Government) EBITDA safe harbour limit percentage would need to be developed in consultation, having regard to policy and integrity concerns.

4. The ALDT amount should be assessed on a forward looking basis only at the time a particular debt is taken out. There should be no requirement to continually reassess the ALDT in relation to a particular borrowing unless that borrowing is refinanced or reconstituted.

5. The application of the ALDT should be simplified for entities that only have borrowings from unrelated entities. Inherently, the debt levels maintained by Australian entities in these circumstances should satisfy the ALDT unless there is express or implied credit support from foreign parents or affiliates, or by having regard to controlled foreign operations. In these circumstances, a simpler ALDT should be applied by requiring relevant taxpayers to only assess whether such support exists and, if so, whether that has had any effect on the actual Australian debt levels.

6. We do not support the introduction of mandatory or optional advance thin capitalisation agreements.

7. Taxpayers should have a reasonable period after the year in which reliance on the ALDT is sought in order to prepare appropriate documentation to support their access to the ALDT. If the recommendation to assess the ALDT on a forward looking basis is accepted (as per 4 above), then it needs to be recognised that such documentation can be prepared some period after the effective date of its application.

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Should you have any queries or would like to discuss this submission further please do not hesitate to contact in the first instance either Peter Janetzki on (03) 8650 7525 or Tony Stolarek on (03) 8650 7654.

Yours faithfully

Ernst & Young

Appendix

1. The ALDT must remain available to all taxpayers

The thin capitalisation safe harbour debt amount test (safe harbour test) enables all taxpayers to calculate a minimum thin capitalisation position with a relative degree of ease and certainty. However, the safe harbour test is based on a "*one size fits all*" methodology. In reality there are significant variations in what constitutes appropriate gearing levels across different industries and taxpayer circumstances – and the thin capitalisation provisions need to accommodate these differences.

The thin capitalisation arm's length debt amount test (ALDT) therefore plays an important role for many taxpayers that are seeking to claim debt deductions where the application of the safe harbour test and/or worldwide gearing test (where available) does not result in a maximum allowable debt amount that appropriately reflects their legitimate and reasonable debt carrying capacity.

The explanatory memorandum (EM) to the introduction of the current thin capitalisation rules (New Business Tax System (Thin Capitalisation) Bill 2001) supports the role of the ALDT in circumstances where the safe harbour test does not result in an appropriate maximum allowable debt amount:

> "*10.2 The new thin capitalisation rules will contain an arm's length test. Taxpayers will be able to use this test where they fail the safe harbour test but their gearing could otherwise be justified or acceptable.*
> *…*
> *10.6 The arm's length test for non-ADIs focuses on what the business acting at arm's length would borrow and what independent commercial lenders would lend to the business on arm's length terms. The arm's length debt amount that is determined may be different to the safe harbour debt amount.* "

The safe harbour test may not produce appropriate outcomes where entities have assets or other economic value (for simplicity referred to below as 'assets') that are not recognised for the purpose of that calculation, but which support cash flows and therefore the debt serving capacity of the entity.

Examples of circumstances/ industries where reasonable debt levels might exceed the safe harbour test limit would include (but are by no means limited to):

- Infrastructure sectors:

  The nature of some infrastructure projects (particularly social infrastructure) is that equity participants base their investment on a low risk/ lower return (charge) basis. This type of investment has been particularly attractive to pension/ superannuation funds that are seeking stable returns over a longer term. Normal gearing ratios for such projects are generally well in excess of the safe harbour test limit.

- Property sectors:

  Many property investments produce long term and relatively stable cash flows which are backed by real assets. Such businesses therefore can typically support a higher gearing level that other entities.

- Services businesses:

  The services sector is becoming a more significant component of the Australian economy. Services businesses typically produce their cash flows off a proportionately lower asset base. As such, the balance sheets for these businesses do not typically reflect their borrowing and debt servicing capacity.

- Businesses that have grown organically:

  Many "home grown" businesses in Australia will have accumulated significant value over many years which is reflected in their cash flows and profits (and therefore borrowing capacity) but not in their accounting balance sheets.

Some businesses such as those in the private hospital industry will have a combination of different features such as strong and consistent cash flows that allow them to access the debt markets and reasonably achieve gearing levels that exceed the balance sheet safe harbour limits. For example, some private hospital operators may both own and lease their properties, have over time grown their business operations organically and through acquisitions, generating stable and consistent cash flows which support and service debt levels that exceed balance sheet safe harbour limits. These businesses should be able to continue to access the ALDT to support debt levels when additional funding is required (for example to support their expansion).

In our view, it is not possible or appropriate to attempt to statutorily define a narrower class of taxpayers who have exclusive access to the ALDT without substantial risk of exclusion for many businesses with a legitimate and reasonable entitlement to access higher gearing levels that the ALDT would allow in their own specific facts and circumstances. For this reason, our strong submission is that the ALDT should continue to have broad application.

2. The ALDT needs to remain flexible in its application

The ALDT needs to remain flexible in its application to enable it to be accessed by different classes of taxpayers as circumstances allow. By definition, the ALDT requires an evaluation of factors peculiar to a particular taxpayer and, as such, should not have its application constrained by the introduction of prescriptive formulas or other mechanisms.

In this regard, we submit that the ALDT should require consideration of all relevant factors and/or assumptions that would be objectively considered from both an independent lender when assessing the creditworthiness of an entity and borrower perspective. The legislation should not exhaustively prescribe the list of relevant factors that an independent lender would or would not consider, or provide an indicative weighting applicable to those factors. Relevant factors and their weighting will change over time in line with general economic conditions, market forces, competition amongst lenders and borrowers etc. In our view, neither the legislation nor the ATO should need to provide prescriptive formulas and mechanisms for taxpayers to help achieve ALDT certainty because this will erode the ALDT's flexibility.

We strongly disagree with any move to statutorily or arbitrarily exclude certain factors from being available for consideration in the ALDT analysis. In our view, the ALDT must serve as an alternate thin capitalisation test that is independent from the safe harbour tests and should not be limited or restricted by accounting concepts dealing with the recognition of assets and liabilities. In particular, the notion that internally generated intangibles or goodwill should be excluded from the ALDT assessment is inappropriate given that it is exactly these factors that can be reflected in a taxpayers' cash flow and therefore debt serving capacity, which makes the safe harbour test inappropriately restrictive. It is the existence of these factors that should draw the application of the ALDT on a reasonable basis.

The EM for the current thin capitalisation rules again supports this:

> "*10.10 The focus of the arm's length debt analysis is on the Australian operations of the investing entity. The analysis looks to the assets of those operations as the source of cash flows to meet the debt repayments and the other liabilities of the operations.*
> ***…***
> *10.13 The analysis involves a consideration of the factors that an entity would consider when arranging the finance for its operations, and the factors that a prudent commercial lender would*

consider when deciding whether to provide the finance, and on what terms it would provide that finance."

We are concerned (as noted in the discussion paper) that the ATO has queried the inclusion of assets such as internally generated goodwill in the assessment of what amount an independent commercial lender would be willing to lend an entity. By its definition, the ALDT requires consideration of those factors that would be taking into consideration by an independent lender and independent borrower. There should be no artificial restriction on how those real life factors are defined and applied.

The importance of this proposition is demonstrated in the following simplified example of an Australian company that has developed a successful technology-driven manufacturing operation from its own skill and efforts which is economically reflected in valuable business goodwill. Scenario 1 below illustrates a hypothetical maximum allowable debt level using the balance sheet safe harbor method without regard to the value of goodwill that cannot be recognised under either the Australian accounting standards or thin capitalisation modifications. If that same business was acquired by a new owner for its market value (say $820 million in this example), the new owner should ordinarily be able to recognise the cost of the acquired goodwill resulting in a higher debt amount under the safe harbor test as illustrated in Scenario 2.

Illustrative example - Australian technology company

All amounts in $millions

		Scenario 1		Scenario 2	
Balance Sheet Profile	**Economic value**	**Accounting Value**	**Safe harbour test**	**Accounting Value**	**Safe harbour test**
Plant & Equipment	100	100	100	100	100
Net Working Capital	200	200	200	200	200
Identified intangibles (recognised for accounting purposes and s820-683 – cost $50m, value $120m)	120	50	120	120	120
Business Goodwill	400	Nil	Nil	400	400
Total	820	350	420	820	820
Safe Harbour Debt Amount (@60%)			252		492
Safe Harbour Debt Amount (@75%)			315		615

Without the opportunity to utilise the ALDT, the more favourable outcomes under the safe harbour test following the sale of the business (as in scenario 2) would represent a significant tax bias against taxpayers growing their business compared to acquirers of those same businesses.

3. Creation of an Alternate Safe Harbour Test based on EBITDA

A substantial portion of taxpayers who rely on the ALDT do so because the safe harbour test only has regard to accounting balance sheets and not cash flows and debt servicing capacity. This can be contrasted with modern bank lending practices which have regard primary regard to cash flows and servicing ability.

To provide an option for taxpayers in this category to obtain thin capitalisation certainty, we support the introduction of a second (and alternate) safe harbour test based on a set percentage of EBITDA. Such a test should not be in substitution for the existing balance sheet based safe harbour test but should rather

be an alternative to those taxpayers for which the safe harbour test is inappropriately restrictive but nonetheless might simply and objectively warrant a higher gearing level based on cash flows.

Conceptually, this should not erode the corporate tax base because taxpayers which would benefit from this test might reasonably be expected to satisfy the ALDT in any event. An appropriate EBITDA safe harbor limit percentage would need to be developed in consultation having regard to policy and integrity concerns.

4. Replacement of current testing requirements with a forward looking test

The requirement to evaluate satisfaction of the ALDT on an annual basis having regard to factual assumptions and relevant factors prevailing during each income year may create outcomes which are disconnected from the real "arm's length" facts and circumstances that are taken into account in setting a particular debt level.

In our view, the ALDT amount should instead be assessed on a forward looking basis having regard to the factual assumptions and relevant factors existing as at the time a particular debt was taken out.

In the case of loans that are struck on arm's length terms, the requirement to reassess the ALDT amount should only arise where the loan is refinanced or reconstituted. The legislation might prescribe what constitutes a reconstitution for this purpose such as when there are material changes to the terms of the loan. We do not support the compulsory re-testing of the loan after the expiration of a defined period. However should there be such a restriction then it should be a minimum of not less than 7 years, in line with what might be considered to be the usual term of business loans.

In the case of loans that are not struck on arm's length terms or which provide the borrower an ability to call for repayment at any time (at call loans), the ALDT should continue to require annual re-evaluation having regard to prevailing facts and circumstances.

We consider that this approach should both ease the ALDT compliance burden on taxpayers with legitimate financing arrangements which have been struck on arm's length terms and more accurately calculate a true "arm's length" debt amount by reference to the commercial considerations and outcomes that independent parties would actually have regard to.

5. Simplified ALDT application for entities with only third party debt

The fundamental question underpinning the ALDT is whether debt levels held by an Australian entity or group could reasonably be sustained on a stand-alone basis and without regard to any express or implied support provided by a foreign parent or its affiliates (in the case of inward investors) and/ or without regard to the value and cash flows provided by controlled foreign operations/ entities (in the case of outward investors).

The EM for the current thin capitalisation rules states:

> "*10.17 In determining how an independent entity dealing at arm's length with other parties would fund the Australian operations, the effect of any financial or credit support from its associates is ignored, as are foreign assets it may hold. The analysis is then conducted as if the taxpayer were an independent entity that finances its Australian operations without the benefit of any financial or credit support from its associates."*

In circumstances where Australian entities only have debts owing to unrelated and independent lenders it is reasonable to assume the arm's length nature of those debts in a broad context. It would therefore seem reasonable to limit the ALDT analysis to an enquiry as to whether:

(i) The Australian entity has benefitting from any express or implied credit support provided by its international related parties in obtaining that debt level; and/ or

(ii) The value and/ or projected cash flows of the controlled foreign operations of the Australian entity have impacted upon its reasonable debt levels.

If the answer to both these questions is “no” then the ALDT should be taken to have been satisfied in respect of an entity that only has debt owing to unrelated and independent lenders. In these circumstances, the ALDT requirements need only be limited to an analysis of these aspects.

If the answer to either of these questions is “yes” then further analysis would be required to determine whether and to what extent these factors have impacted the actual debt levels owing to the unrelated an independent lenders. This might be particularly relevant for foreign owned Australian entities which can inherently benefit from some level of implied support in some cases. In our view, that analysis should be specifically directed towards determining the debt level that the Australian operations could reasonably have sustained (from borrower and lender perspective) without regard to these factors.

In either case, the level of ALDT analysis required would be substantially simplified by narrowing down the required analysis to the factors that could cause an actual arm’s length lending arrangement to deviate from funding levels that can be sustained under the ALDT as applied within the intended policy.

6. Thin capitalisation advance compliance agreements

We accept the position that taxpayers who want to adopt gearing levels which exceed the safe harbour test (or tests) should need to justify their satisfaction of the ALDT requirements based on a written analysis of the relevant factors. We believe that taxpayers should continue to be able to do this on a self assessment basis (as underpins the Australian tax framework).

We do not support any mandatory or optional advance thin cap compliance agreements in order to access the ALDT, including agreements similar those applying in the United Kingdom. In our view, taxpayers who wish to achieve certainty with respect to their ALDT amounts should be able to do this through the existing private binding rulings processes.

We anticipate that such advance thin capitalisation agreements would merely increase taxpayer costs of compliance and add to the ATO’s administrative burden.

Any additional certainty and compliance savings sought by such advance agreements applying for three to five years may not be necessary if the thin capitalisation rules are modified as recommended above, to apply on a forward looking basis requiring testing only for the commencement year of the loan and at the time of defined events.

7. Extension of time for documentation

Given the level of analysis and documentation that may be required in order to substantiate the ALDT, and the quantum of other compliance obligations of a taxpayer, we support an extension of time for preparation of the ALDT documentation.

As per our observations above, the test should be forward looking from the time the debt is established or other future re-evaluation point. However, in recognition of the fact that the ALDT need only be considered when the safe harbour tests are failed, it may be that reliance on the ALDT is not required until sometime (or years) after the effective testing date. The timing requirements for preparing the ALDT analysis should allow for this.

There should therefore be no time limits on the preparation of ALDT documentation from the time each calculation is made. Rather the period for documentation should be extended to allow completion within a reasonable period of time after the end of the year in which the relevant ALDT analysis is required.