Institute of Chartered Accountants Australia

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Dear Working Group members,

Discussion Paper on the "*Review of the Thin Capitalisation Arm's Length Debt Test*"

The Institute of Chartered Accountants Australia (**Institute**) welcomes the opportunity to make a submission on the discussion paper entitled *Review of the Thin Capitalisation Arm's Length Debt Test* released by the Board on 16 December 2013.

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world. Representing more than 73,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

In summary, this submission sets out the Institute's comments on:

- The importance of the Arm's Length Debt Test (**ALDT**) in situations where safe harbour ratios are exceeded but where debt levels are commercially justifiable by reference to the arm's length principle (section 1)
- Why the ALDT is necessary for taxpayers including those with assets not recognised for the safe harbour debt amount (e.g. internally generated goodwill) (section 2)
- Why access to the ALDT should not be limited in any way(section 3)
- Why an earnings based test should be introduced – the Institute considers that if such a test were to be introduced, it should be optional and not a substitute for an ALDT and/or an assets based test (section 4)
- Ways to reduce compliance costs for taxpayers such as removing the requirement for the determination of an arm's length debt amount annually and allowing an option for the relevant factor analysis to be performed on a prospective basis (section 5)
- Ways to ease the administration burden on the ATO such as harmonisation of the ALDT and transfer pricing rules (section 6).

1. Importance of the Arm's Length Debt Test

The existence of the ALDT is founded in a legitimate policy basis, drawing on the arm's length principle adopted by the OECD[1].This is stated in the Explanatory Memorandum which accompanied the introduction of the test in 2001:

> *"2.6 The prescribed safe harbour debt to equity ratio may be exceeded in circumstances where the funding structure could be maintained on an arm's length basis. In such a situation, no deductions will be disallowed. This change recognises that some funding arrangements may be commercially viable notwithstanding that they exceed the prescribed limits. It also makes the rules more consistent with Australia's DTAs."*[2]

The Explanatory Memorandum goes on to explain:

> "*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."*

Inclusion of the ALDT recognises that although safe harbour rules provide simplicity and certainty, they do not, and cannot, give due weight to differences in business models which, on an arm's length basis, would give rise to different debt-equity ratios depending on the stability or volatility of profits and cash flows. The ALDT therefore plays a crucial role for many taxpayers that are seeking to claim debt deductions where the application of the safe harbour debt amount and/or worldwide gearing test (where available) does not result in a maximum allowable debt amount that appropriately reflects their legitimate debt carrying capacity.

The property and infrastructure sectors are often given as examples of areas where a high level of gearing can be supported. However there are other circumstances where safe harbours do not reflect debt carrying capacity (see below).

2. Taxpayers with assets not recognised for safe harbour debt amount

One circumstance in particular where the safe harbour debt amount calculation may not produce acceptable outcomes is where entities have certain assets or other economic value (for simplicity referred to below as 'assets') that is not recognised for that calculation.

The thin capitalisation safe harbour debt amount calculation only has regard to balance sheets prepared in accordance with the accounting standards, with some further limited recognition of certain internally generated intangible assets for the calculation. The extension of the safe harbour rules to internally generated assets was made to accommodate certain impacts arising from the 2005 adoption of Australian equivalents to International Financial Reporting Standards (AIFRS) in 2008 (refer Tax Laws Amendment (2008 Measures No. 5) Act 2008). These rules will only recognise a limited range of such assets however, including for example internally generated brands, mastheads, publishing titles, customer lists and 'items similar in substance', subject to other recognition conditions.

This approach does not recognise that there may be other assets that are not recognised which support cash flows and the debt serving capacity of the entity.

This is a recognition issue, rather than a valuation issue. We note that where assets are recognised for accounting purposes or under the extension for certain internally generated intangible assets there are now provisions that may allow revaluations to be used for the safe harbour debt amount calculation.

There are numerous taxpayers that have extremely valuable assets that are not recognised by either the accounting standards or the thin capitalisation internally generated intangible assets extension, which generate significant cash flows and revenues. This includes significantly internally generated

[1] OECD *Model Tax Convention on Income and on Capital,* see also *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*
[2] *New Business Tax System (Thin Capitalisation) Bill 2001*

goodwill. Examples of other excluded assets include the value of reserves or resources discovered through exploration. We note that the 2008 amendments to include certain internally generated intangible assets specifically exclude internally generated goodwill (subsection 820-683(1)Income Tax Assessment Act 1997).

Internally generated goodwill and these other assets may be directly relevant when determining the appropriate debt carrying capacity of relevant taxpayers. Because the safe harbour debt amount does not take these assets into account for this calculation of the maximum allowable debt, the ALDT has a vital role to play to ensure that the thin capitalisation rules apply fairly.

The Explanatory Memorandum to the introduction of the current thin capitalisation rules again supports this approach:

> *“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.”* ***(our emphasis)***

The suggestion 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 is a concern and reinforces the need for the ALDT rules to be adjusted to provide clearer law.

The accounting based approach of the safe harbour debt amount calculation must not in any way be imported into the ALDT calculation. Such inappropriate overlay of safe harbour debt concepts defeats the intended role of the ALDT to operate to provide an alternative maximum allowable debt amount.

3. Access to the ALDT should not be limited

The Institute strongly opposes any specific legislative criteria for determining the ability to gain access to the ALDT. Any taxpayer – regardless of the nature of their business activities or investments - should be eligible to apply the ALDT should they so desire.

For instance, a wide range of taxpayers with internally generated goodwill and other non-recognised assets may be affected by any exclusion from the ALDT, across industries, across size of taxpayer and across stages in their development, including for:

- Start-up businesses with an otherwise low accounting asset base
- Mature businesses that have built wealth internally rather than through asset acquisitions

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.

This can be contrasted with the balance sheet position that might arise in respect of those same businesses when they are subject to a change of ownership/control thereby unlocking the internally generated goodwill for accounting purposes on consolidation.

It is therefore necessary that access to the ALDT remains available to such entities, as well as other entities that may separately justify access to the rules because it is common practice to operate with higher debt to equity ratios, including because the particular business may only need a low asset base to generate high revenue/earnings (e.g. in the services industry).

At a practical level, our main concerns with imposing a limitation as to which taxpayers could avail themselves of the ALDT are as follows:

- There would be legislative complexity in defining the criteria by which such eligibility could be determined and potential uncertainty in applying such a definition to specific factual scenarios
- A legislative requirement has the potential to be inflexible to cater for changing economic or business sectors which subsequently should be considered (as a matter of policy) to be capable of accessing the ALDT - that is, although historically, the utilities and construction

sector have accessed the ALDT, this may not be indicative of sectors that in the future will commercially be able to access debt funding at a level greater than the safe harbour limits
- Although the use of Regulations may provide administrative ease to implement, modify or adjust any pre-determined eligibility criteria, taxpayers would still face uncertainty for the future
- Taxpayers that would meet any determined eligibility criteria would continue to need to satisfy themselves and the ATO as to their satisfaction of debt levels having regard to the actual ALDT (that is, a compliance cost burden would remain)

Additionally we reject the proposition that access to the ALDT should be restricted to taxpayers who have an advance ruling or determination approving access to the ALDT. Although we appreciate the need to protect the revenue base, this would seem overly restrictive and results in additional compliance costs for taxpayers. Such a limitation would impose an additional burden on taxpayers who would otherwise be able to satisfy themselves that they have determined an appropriate arm's length debt limit in accordance with the law and any guidelines provided by the ATO. As in all income tax matters, the burden of proof rests with the taxpayer who has the choice to seek a private ruling from the Commissioner to manage any element of uncertainty in the application of the ALDT and manage tax risks, or respond as appropriate to any subsequent ATO inquiry.

The Commissioner of Taxation currently has mechanisms in place to monitor taxpayer reliance on the ALDT and to use such information to follow up specific taxpayers to uncover potential integrity concerns or an incorrect application of the law. Specifically, the current International Dealings Schedule, which is required to be completed and lodged by companies, trusts and partnerships which are subject to the thin capitalisation rules, requires disclosure of whether the ALDT has been relied upon, along with disclosure of the arm's length debt (non-ADI) or capital (ADI) amount. Additionally, the introduction of the Reportable Tax Position Schedule and pre-lodgment compliance reviews enables the ATO to have earlier real-time line of sight over the potential for any breaches of the safe harbour rules where the ALDT may then be used by the particular taxpayer.

The number of taxpayers that potentially may seek to rely on the ALDT as a proportion of the total number of taxpayers affected by thin capitalisation may not warrant any additional disclosures or procedures to be put in place having regard to the balancing of administrative and compliance costs versus protection of the revenue base[3]. We believe that the administrative systems already in place as mentioned above provide the Commissioner with sufficient information or support to address any perceived risks to the revenue in applying the ALDT.

4. Earnings based test–should be optional

The Discussion Paper refers to the findings of the Business Tax Working Group (BTWG) in 2012 where the possibility of an earnings based test was raised as an option in August 2012. It is important here to note that an Earnings Before Interest, Depreciation and Amortisation (EBITDA) test was put forward as an option to replace the current thin capitalisation safe harbours and ALDT (i.e. as a stand-alone test). As such, the Institute did not support this option in its submission to the BTWG of 21 September 2012. Our reasons included the potential for such a test to be extremely volatile in its outcomes, for example where there are depressed circumstances in one year, accounting-driven write downs in one year; or significant bad debts write-offs in one year. We also had concerns that the proposal was under-developed.

Although an EBITDA test related to available cash flow would certainly not suit all taxpayers and would need to be considered only as optional for particular taxpayers, it is considered by many to be a more appropriate test for service industry companies. Such companies may well be an important part of Australia's future in the Asian Century (i.e. businesses that are not "asset heavy", with the possible exception of goodwill, which if internally generated does not contribute to the thin capitalisation base in any event).

[3] Paragraph 2.32 of the of the Board's Discussion Paper indicates that 95% of listed companies would meet the proposed lower safe harbour limits and hence would not be relying on the ALDT. Furthermore, paragraph 3.32 and 3.33 of the Discussion Paper implies that a relatively small proportion of taxpayers who failed to meet the safe harbour limits in 2011 availed themselves of the ALDT (just over 11%). It is acknowledged that this low percentage may be due to the current complexity of applying the ALDT and the incumbent compliance costs of seeking to adopt it.

An EBITDA based test is also more likely to assist property owning taxpayers support the arm's length nature of higher (than safe harbour) gearing levels on the basis of having secure, longer term lease arrangements with high quality tenants generating stable returns.

However, further work would be needed to determine the efficacy of an EBITDA test. Possibly, now is the time to commence that work. We do emphasise that we consider that an earnings based test should be optional and not a substitute for an ALDT and/or an assets based test.

5. Reduction in compliance costs for taxpayers

We have addressed a number of issues raised in the questions in the Discussion Paper below.

Removing the requirement to apply the ALDT annually (question 4.1(a))

The Institute supports the option to apply the ALDT only in the year in which the borrowing took place, subject to reassessment when there are material changes. This is reflective of the manner in which third party borrowers and lenders might be expected to deal with each other.

However, we do not share the view that the ALDT is required to be applied annually in the first place; and submit that the flexibility to apply the ALDT only at the time the loan(s) was made is already available to taxpayers under the law. The thin capitalisation rules only require the determination of an arm’s length debt amount to be undertaken annually. The distinction, though subtle, is an important one. Legislative clarity would be welcome.

Attention is brought to the fact that the relevant factors in paragraphs s820-105(3)(k) and 820-215(3)(j) of the Income Tax Assessment Act 1997 allow taxpayers to rely on analysis prepared at the time the debt capital was raised if there have been no material changes in the relevant income year.[4]

The Explanatory Memorandum at paragraphs 10.55 and 10.56 states:

> *‘The analysis of the relevant factors in the year the entity last raised debt capital may be the most important analysis in some circumstances. Specifically, where the entity has not raised debt capital in the intervening time and the relevant factor analysis for the year in which debt was last raised and the current year would be similar, the entity may rely on that earlier analysis.*
>
> *The purpose of adopting this factor is to eliminate the compliance burden of doing a comprehensive arm’s length analysis every year when it is clear that nothing has materially changed. For example, it would be expected that the same Australian business is operating, the nature of the assets is substantially the same, its equity funding is the same and the entity still has the same or similar capacity to repay its liabilities.’*

This recognises that under typical commercial lending arrangements, a lender has a contractual obligation to continue to advance funds provided that the borrower has not violated any of the loan facility‘s conditions for funding, e.g. breach of financial covenants.

We suggest the criteria that could be used for determining ‘material changes’ include where there has been a significant change in the nature of the taxpayer’s business, new debt is raised in the relevant income year and/or where there is a deterioration in the financial performance of the borrower such that it would result in a breach of financial covenants that would be expected to be incorporated in an arm’s length loan agreement having regard to the borrower’s credit profile.

It would be more consistent with the transfer pricing notion of arm's length conditions if such criteria were closer to those (narrower) circumstances that either represent an event of default or otherwise give a third party lender the right to review the loan. In this regard, for a material change in the taxpayer's business to trigger an ALDT re-determination, it should be a 'material adverse change' (otherwise it should not adversely impact the borrower's credit position or arm's length borrowing capacity as is typically defined in loan agreements).

Retrospective versus prospective focus (question 4.1(b))

The Institute supports the option to allow the relevant factor analysis to be performed on a prospective basis using projected financial data on the basis that this reflects commercial practice.

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[4] See Taxation Ruling TR 2003/1, paragraphs 49 and 50.

A commercial lender will typically look at the current and projected cash flows and earnings as a source of funds from which the debt will be serviced and repaid, particularly for start-up companies and certain Public Private Partnership (PPP), infrastructure and property projects where there is a level of certainty and stability over long-term revenue streams.

Likewise, for companies that aim to maximise shareholder wealth, the projected internal rates of return (IRR) are a critical consideration in assessing the optimal level of gearing. By leveraging at an interest rate less than the IRR, the post interest returns would be higher with the inclusion of the debt than without.

Independent lender and borrower tests (question 4.2(a))

The Institute recognises that the application of the independent borrower test suffers from some limitations at a practical level but is of the view that the test should be retained as it an important integrity provision.

However, as noted elsewhere in this submission, we believe there is considerable scope for simplifying the independent lender and borrower tests by removing the requirement for annual testing when there are no material changes in the relevant income year and allowing the tests to be applied using forecasted financial data.

Simplification of ALDT where no related party debt (question 4.1(e))

The Institute supports simplification of the ALDT where there is no related party debt or no parent guarantees. We agree with the conclusion in paragraph 4.22 that where the relevant debt interest has been borrowed from a commercial or third party lender, the amount borrowed should be accepted as an arm’s length debt amount, subject to specified qualifications or limitations. These would include the absence of explicit parent guarantees or ‘back to back’ arrangements.

We note that the requirement to exclude guarantees and other forms of explicit support should not include implicit support because:

- Unlike explicit support, it is often not clear whether third party lenders have taken account of implicit support in providing finance to the borrower. The borrower would not typically be aware of the extent to which a third party lender's credit policies or practices have factored this into the terms of the lending arrangements, including the debt amount.
- It is consistent with transfer pricing practice, under which implied support should be priced into the arm's length interest rate, that any implied support should also be factored into the arm's length level of debt (for thin capitalisation and ALDT purposes).

Although it could be a matter for further consultation if the proposed simplification is accepted, the Institute’s preliminary view is that the definition of ‘associate’ in section 318 of the Income Tax Assessment Act 1936 should be used in identifying related party debt. We see merit in using “black letter law” that is well understood by tax professionals.

Family group - consolidated basis

If, contrary to the Institute’s submission above, commercial or third party debt is not excluded, we consider that small to medium enterprise (SME) taxpayers should be permitted to apply the ALDT on a consolidated ‘family group’ basis. The definition of a ‘family group’ in the trust loss rules in section 272-90 in Schedule 2 to the Income Tax Assessment Act 1936 could be used for this purpose.

Allowing SME taxpayers to apply the ALDT in this way would allow the arm’s length debt amount to be determined based on the family group’s capacity to support the debt. Importantly, this approach recognises that it is commonplace for all entities within a family group to be called upon to support a loan from an external party (i.e. cross guarantees which would be ignored as a result of the proposed consolidation).

Property groups/other large groups which are not consolidated (paragraphs 4.26-4.29 of Discussion Paper)

It is not always the case that large corporate groups are able to form a tax consolidated group for income tax purposes. For example, trust groups are in this situation such as those found in the property or infrastructure industry. It is common that cross guarantees are provided within these groups (e.g. for legal and other non-tax reasons, assets are often owned in special purpose vehicles which rely on these cross guarantees to secure funding). A third party lender providing funding to these entities will have regard to the cross guarantees provided within these groups. However the ALDT does not allow these guarantees to be taken into account in determining an arm's length debt amount.

On this basis, it is submitted that as a minimum cross guarantees provided within wholly owned Australian groups not able to form a tax consolidated group (such as trust groups) should be taken into account when determining the arm's length debt amount of a particular entity within that group. This is no more favourable than the position of a tax consolidated group that effectively has the ability to take into account cross guarantees due to the single entity rule. Subject to addressing any integrity concerns, this principle could be extended to cover cross guarantees provided within Australian groups that have a common Australian controller or within stapled groups where the lender takes security over all of the assets of the stapled group.

Advance thin capitalisation agreements (question 4.1(g))

We do not support the introduction of a new system of 'advance thin capitalisation agreements' including agreements similar to those applying in the United Kingdom.

The existing private binding rulings system should be sufficient for taxpayers wishing to obtain certainty with respect to their thin capitalisation ALDT positions.

In addition, the additional certainty and compliance savings which may have been sought by such advance agreements applying for three to five years will not be necessary if the thin capitalisation rules are modified as recommended above (i.e. to apply on a forward looking basis requiring testing only for the commencement year of the loan and at the time of a significant material variation to the terms of the loan). A private binding ruling should be able to be issued at the commencement of the loan to apply until such a variation or the end of the minimum period occurs.

We also expect that taxpayers are likely to be more prepared to work through the rulings system under an improved ALDT that does not require testing every year.

Any new system of advance agreements would merely increase the costs of taxpayer compliance. It would also be an additional administrative burden on the ATO, as identified in the Discussion Paper.

In addition, obtaining private binding rulings must remain solely as an option for the taxpayer and must not be mandated in order to obtain access to the ALDT or otherwise.

Exemption for certain special purpose entities (question 4.1(h))

The Institute does not consider there is a need to provide further legislative or administrative guidance (apart from that already planned) on the exemption from the thin capitalisation rules for certain special purpose entities provided by section 820-39 of the Income Tax Assessment Act 1997.

The Discussion Paper (at paragraphs 4.32 to 4.34) refers to legitimate concerns raised about the Interpretative Decision issued by the ATO relating to the exemption from the thin capitalisation rules for certain special purpose entities (ATO ID 2012/31). As stated, this ATO ID was withdrawn in May 2012.

There have been further developments since, which the Institute was closely involved in (through its participation in the National Tax Liaison Group (NTLG) – International Subgroup (now disbanded)).In summary, the withdrawal of ATO ID 2012/31 was followed by the issue of draft Taxation Determination TD 2012/D11 in December 2012. This in turn was withdrawn following consultation as it too had the effect of unduly restricting access to the exemption for a range of securitisation vehicles.

Residual concerns that the ATO had in respect of particular specific securitisation arrangements[5] were then the subject of targeted consultation undertaken by the ATO with experts in the area. This was completed towards the end of last year with a draft Tax Determination issued on 12 March 2014 (TD 2014/D8:*Can the exemption in s 820-39 of the ITAA 1997 apply to the special purpose finance entity established as part of the "securitised licence structure" used in some social infrastructure Public Private Partnerships*?)

6. Easing the administration burden on the ATO

We submit that if the measures to reduce compliance costs as outlined in this submission are adopted, then this will also act to ease the administrative burden for the ATO.

We further consider that there is scope for harmonising the ALDT and transfer pricing rules as a means of easing the administrative burden for the ATO while at the same time maintaining integrity of the thin capitalisation rules.

This could be achieved by:

- Relaxing the requirement under the factual assumptions to isolate the assets and income of the Australian business. This is in alignment with the approach generally taken when evaluating a borrower's credit profile for purposes of determining an arm's length interest rate under the transfer pricing rules. Furthermore, the proposed introduction of a targeted anti-avoidance measure in relation to offshore financing would seem to have the potential to render the need for this factual assumption redundant in any case[6].
- Clarifying that the requirement to exclude guarantees and other forms of credit support does not extend to *implicit* credit support provided by an associate. In practice, transfer pricing requires that the impact of implicit credit support is taken into account in assessing the credit profile of the borrower for the purposes of determining arm's length interest rates.

By harmonising the ALDT and transfer pricing rules where possible, this would facilitate the administration of the ALDT within the existing procedures for administering the transfer pricing rules.

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If you would like to discuss any aspect of this submission or require any further information, please do not hesitate to contact me on 02 9290 5609 at first instance.

Yours sincerely

Michael Croker
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[5] Non-application of Part IVA to the securitised licence structure – 'The ATO had raised the possibility that the 'securitised licence' structure employed to deliver social PPPs potentially attracts Part IVA' – Refer ATO Consultation Hub: http://www.ato.gov.au/General/About-consultation/

[6] The government announced on 6 November 2013 that it would not proceed with the former government's proposal to deny deductions made under section 25-90 of the *Income Tax Assessment Act 1997* but would introduce a targeted anti-avoidance measure. The measure is currently under development and initial consultation has taken place. http://jbh.ministers.treasury.gov.au/media-release/017-2013/