THE TAX INSTITUTE

THE MARK OF EXPERTISE

24 March 2014

Ms Elizabeth Jameson
The Board of Taxation
c/ The Treasury
Langton Crescent
CANBERRA ACT 2600

By email: taxboard@treasury.gov.au

Dear Elizabeth,

Review of the Thin Capitalisation Arm's Length Debt Test

The Tax Institute is pleased to have the opportunity to make a submission to the Board of Taxation (**Board**) in relation to its Discussion Paper dated December 2013 on the arm's length debt test (**ALDT**) as it applies to the thin capitalisation rules (**Discussion Paper**).

Overarching comments

Some of our responses to the specific questions listed in Appendix A of the Discussion Paper are contained below under the heading 'Specific responses' (although we have not provided answers to all 31 questions).

In summary, our main submission points are as follows:

- There does not appear to be a cogent policy reason for removing the ALDT from the thin capitalisation provisions, particularly in light of the proposed safe harbour debt test changes;

- Certain industries may need to resort to the ALDT for various reasons. For example, for the infrastructure industry, entities may attract higher levels of gearing on an arm's length basis. For services entities with low asset base or internally generated goodwill, the safe harbour debt test will penalise them. Hence, allowing access to the ALDT for all taxpayers is essential to ensure that tax outcomes do not drive outcomes or penalise certain types of businesses and a level of playing field is created across all businesses;

- In addition, the ALDT should not be restricted to taxpayers in certain defined industries for the following reasons:

    - We do not consider that broad access to the ALDT will cause significant problems for the ATO as not all taxpayers that can, will rely on the test and the ATO is still able to conduct appropriate risk assessments with

respect to debt deductions.

- Attempting to legislatively define activity in certain industries is likely to prove difficult. Such definitions are likely to also pose integrity risks that would require stringent tests to address.

- Greater harmonisation of the documentation requirements of the transfer pricing legislation and the ALDT would reduce compliance costs.

- The incremental benefit versus compliance cost of each assumption in the ALDT should be carefully considered.

- Consideration could be given taxpayers being able to enter into advance thin capitalisation agreements with the ATO, similar to those entered into in the UK with the HRMC.

- Low asset service companies or companies with valuable intangibles may benefit from a compliance perspective from a safe harbour test based on earnings or interest cover ratio (like New Zealand) as an alternative to the arm's length and safe harbour tests. These companies may currently be disadvantaged as these valuable assets are not recognised under the current safe harbour test (as they are not assets recognised for accounting purposes).

- In relation to the exemption for special purpose entities, we welcome the revised draft taxation determination, TD 2014/D8, ruling the exemption from thin capitalisation does apply to a special purpose entity established as part of a 'securitised licence structure' that is used in social infrastructure public private partnerships. Therefore, we do not think further legislative guidance is required at this stage.

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If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours sincerely,

Michael Flynn
President

Appendix A

Specific responses

Question 4.1(a) – The ALDT should only be applied in the year in which the borrowing takes place, every five years, and when there are material changes. This should accord more with commercial practice in relation to the testing of loans.

Question 4.1(b) – The factual assumptions and relevant factors should be prospectively focussed to better reflect conditions operating relevant economic conditions affecting Australian operations.

Question 4.1(c) – The above relaxing of the annual testing requirement would go some way to shifting from a retrospective to prospective focus in the rules.

Question 4.1(d) – Introducing a safe harbour specifically relevant to service companies would be in accordance with steps taken in other jurisdictions such as New Zealand. Additional (potentially industry based) safe harbours via administrative practice (rather than via amendments to the law) where the risk of revenue is low will reduce the need to rely on the ALDT for those entities. Such an option is also likely to be easier to implement and more flexible in application. However, such a measure should not preclude any entities from using the ALDT as an alternative in the event that they do not the definition of “service company” for the purpose of the additional safe harbour concession.

Question 4.1(e) – debts between unrelated parties should not be subject to a full ALDT analysis.

Question 4.1(f) – There is merit is considering that creditor support from related parties be recognised in particular circumstances when they correspond to ordinary commercial dealings.

Question 4.1(g) - Large groups in the UK can enter into thin capitalisation agreements with the HMRC. These arm’s length agreements are commonly used by large private equity owned groups seeking certainty about the deductibility of shareholder debts. Our understanding is the UK model requires the taxpayer to maintain an agreed interest cover and gearing ratio (negotiated with the HMRC based on facts and circumstances). If the covenants are met, then no thin capitalisation disallowance will arise. There is merit in considering the option of being able to enter into similar types of agreements with the ATO in the Australian context. The administrative burden for the ATO in ensuring compliance with these ruling requests should not be significant as the number of requests should not be that great.

Question 4.1(h) – further legislative is not required regarding the exemption for special purpose entities at this stage.

Question 4.1(i) – There is merit in considering a safe harbour test based on earnings or interest cover ratio (like New Zealand) as an alternative to the arm’s length and safe

harbour tests. Low asset service companies may currently be disadvantaged with the current safe harbour tests as these valuable assets are not recognised under the current safe harbour test (as they are not assets recognised for accounting purposes).

Question 6.1(a) - There should not be a limitation on eligibility to access the ALDT. This would merely shift the uncertainty and compliance burden of the ALDT to whether a business falls within the relevant industry able to access the test.