Australian Private Equity &
Venture Capital Association Limited

13 March 2014

Ms Teresa Dyson
Chair, Board of Taxation
c/- The Treasury
Langton Crescent
PARKES ACT 2600

By email: taxboard@treasury.gov.au

Dear Teresa,

Review of the thin capitalisation arm's length debt test

The Australian Private Equity and Venture Capital Association Limited (AVCAL) welcomes the opportunity to comment on the Board of Taxation's (the Board) discussion paper titled 'Review of the thin capitalisation arm's length debt test'.

AVCAL represents the venture capital (VC) and private equity (PE) industry in Australia, which has a combined total of over $24 billion in funds under management for a wide range of domestic and offshore investors, including Australian-based industry and retail superannuation funds.

VC and PE firms invest billions of dollars in early stage and established businesses spanning many value-adding sectors across our national economy. These investments help to support a total of more than half a million jobs, and contribute over four per cent every year to Australia's national economic output.

AVCAL supports the Board's review of the arm's length debt test (ALDT) to identify how the existing rules can be amended to deliver more commercially effective outcomes whilst minimising the compliance obligations associated with the application of the thin capitalisation regime.

This review represents an opportunity for the Board to ensure that Australia offers investors in our economy with an efficient and globally competitive tax environment that is supported by a high degree of policy certainty. Such certainty will help to foster an economic environment in which businesses will be better able to make long-term decisions about the allocation of capital towards investment in Australian businesses. The criticality of long-term investment into Australia is a major national economic priority, which is vitally important to supporting the growth of new industry sectors and employment opportunities over the medium and longer-term. Our tax system must play a supporting role in helping to guide the structural transformation of the Australian economy.

For these reasons, AVCAL supports retaining the ALDT as an additional, and independent, thin capitalisation test that should be available to all relevant taxpayers – having regard to their own unique circumstances. There should not be any attempt made to limit or restrict access to the ALDT rules by virtue of the Government's decision to reduce the key safe harbour thresholds within the existing thin capitalisation regime.

We believe that it is important that the ALDT rules retain an appropriate degree of flexibility in the manner in which they are applied. In our view, it would be difficult to prescribe in legislation how the ALDT should apply in the context of a wide array of specific industries sectors or classes of taxpayers. Because the ALDT requires an evaluation of a range of factors that are specific to each individual taxpayer, imposing overly narrow thresholds to the test would make it difficult to provide the degree of certainty and precision that would fulfil the policy objective of these rules.

With this in mind, the recommendations set out in our submission are focussed on how the operation and application of the test can be improved, without detracting from an appropriate degree of taxpayer-specific flexibility or eroding the integrity of the regime.

As the Board will be aware, many taxpayers rely on the ALDT because the 'safe harbour test' is deemed not to be appropriate for their specific or unique circumstances. The safe harbour test is solely reliant only on the balance sheet position of the borrower, and not cash flows and debt servicing capacity, which stands in direct contrast with current bank lending practices, which have a primary focus on cash flows and servicing capacity.

To provide an option for taxpayers in this category to obtain certainty in relation to their thin capitalisation position, AVCAL supports the creation of a new additional safe harbour test that is based on a set percentage of EBITDA. In our view, such a test should not serve as a substitute for the existing balance sheet-based safe harbour test, but should instead be put in place as an alternative test for those taxpayers for whom the safe harbour test is inappropriate in the context of either their particular circumstances or the broader industry sector in which they operate. AVCAL would be pleased to assist the Board, and the Government, with the design of a new EBITDA safe harbour limit which encompasses an appropriate integrity framework to ensure the intended policy objectives are achieved.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me directly on (02) 8243 7009.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL

AVCAL'S RESPONSE TO SPECIFIC QUESTIONS CONTAINED IN THE BOARD'S DISCUSSION PAPER

Discussion Paper Chapter 4: Reduction of compliance costs for taxpayers

---

The following sets out AVCAL's response to Chapter 4 of the Board of Taxation's discussion paper.

Consultation Questions

Question 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?

AVCAL supports simplifying the requirements of the ALDT in areas where they appear to add little to integrity, such as the need to apply the test in relation to existing debt every year (even though there might not be material changes to debt levels).

As recognised in the Discussion Paper, the requirement to evaluate satisfaction of the ALDT on an annual basis, and applying the required 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 at the time of borrowing.

AVCAL's view is that the ALDT should only be applied in the year of borrowing and not annually, where the ALDT amount should be assessed on a forward looking basis based on the factual assumptions and relevant factors existing at the time the debt was taken out.

This would more appropriately align with the commercial realities of an arm's length lender who would assess the loan at the time of agreeing to make the loan. Such a lender would then protect its go forward position by including covenants in the lending arrangements that could trigger a review if those covenants were breached.

In the case of loans that are struck on arm's length terms, AVCAL is of the view that the requirement to reassess the ALDT amount should only arise:

- If the loan is refinanced or reconstituted; or
- When there is a material change to the terms of the particular loan (such as a change in interest rate, loan term, identify of the borrower, loan currency or other changes that are outside the ambit of the loan agreement); or
- At the end of any term specified in the loan agreement which allows for the loan to be refinanced or repaid (even if no such refinancing or repayment actually occurs); or
- When an event occurs which causes any of the covenants in the loan to be breached or otherwise provides the borrower with a power to call for repayment or reassessment; or
- Otherwise, after the expiration of a defined period (say five years).

Question 4.1(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?

AVCAL's view is that the ALDT assessment should be prospectively focussed rather than retrospectively.

Relevant factual assumptions and their weightings will change over time in line with general economic conditions, competition amongst lenders and borrowers, and various other factors, and the ALDT needs to be able to accommodate this. If the relevant factors and their weightings are assessed on a forward looking basis, concerns about differing approaches to calculating average values "throughout the income year" will become of less significance.

Question 4.1(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?

As indicated above, AVCAL's preference would be to maintain an ALDT that is prospectively focussed rather than retrospectively.

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 ease the ALDT compliance burden on taxpayers with legitimate financing arrangements which have been struck on arm's length terms. In addition, it would more accurately reflect a true "arm's length" debt amount by reference to the commercial considerations and outcomes that independent parties would have considered at the time of borrowing.

Question 4.1(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?

To provide an option for taxpayers to obtain thin capitalisation certainty, AVCAL supports the creation of an additional safe harbour test based on a set percentage of EBITDA.

A key advantage of the existing safe harbour test is that it provides certainty and reduces compliance costs for businesses. However, for certain industries and businesses, the existing safe harbour rules do not adequately take into account the relevant factors considered in the credit risk assessments as part of ordinary commercial lending practices. For example, businesses in non-capital asset intensive industries (e.g. services) may be significantly disadvantaged by the safe harbour test on the basis that material assets such as internally generated goodwill may not be recognised for accounting purposes.

In particular, it is evident that in some circumstances the existing safe harbour test does not effectively capture key financial ratios utilised as part of modern bank lending practices, such as strong cash flows and debt servicing ability.

AVCAL's position is that the additional safe harbour test should substitute the ALDT or the existing balance sheet based safe harbour test. Instead, it should be an alternative option made available to taxpayers to remedy the deficiencies in the existing tests experienced by those taxpayers for whom the existing safe harbour test is inappropriately restrictive but nonetheless would, in an objective lender's assessment, be justified in maintaining higher gearing levels based on their cash flows.

Question 4.1(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?

AVCAL supports the proposition that the ALDT should remain flexible in its application and therefore impose less onerous testing requirements for entities whose debt profile does not include any related party debt. In these circumstances, it may be appropriate to exclude such entities from the application of the thin capitalisation rules altogether.

The exclusion of such entities from the thin capitalisation rules would be particularly appropriate for inbound groups that have no foreign assets or operations under their Australian entities, and are not provided with any express or implicit financial support from their foreign parents.

Where this type of exclusion or simplification of the ALDT is adopted, it will be important for the concept of 'related party debt' to be appropriately defined having regard to modern commercial lending practices.

There is currently no definition in the tax legislation of the term 'related party debt'. However, it is noted that in the context of proposed amendments to the treatment of bad debts written off between related parties, the Treasury discussion paper titled 'Improving the tax treatment of bad debts in related party financing' dated July 2012 proposed to insert a definition of 'related party' which includes:

- an "associate" (defined in section 318 of the *Income Tax Assessment Act 1936*); and
- an "associated entity" (defined in section 820-905 of the *Income Tax Assessment Act 1997*).

If a similar concept were to be adopted in the context of the ALDT, AVCAL is of the view that this would produce an overly restrictive approach, particularly in private equity transactions where non-bank lenders such as private debt funds are utilised.

As companies look for alternative sources of funding beyond the primary loan markets, it is becoming increasingly common for corporates to access mezzanine and senior debt financing from private debt funds. It is possible that, after tracing through such funds to the ultimate investors, there may be common passive investors in both the private debt fund and the private equity funds which have lent and invested respectively into the company.

A definition of related party which would require testing and tracing (such as referencing the definition of the existing definition of 'associate' in the tax law) would provide an onerous compliance burden which is unlikely to be discharged, given the company's limited access to information in respect of upstream investors in a mezzanine debt fund. In these circumstances, where both a private equity fund and debt fund are invested in the same portfolio company, the mere fact that the debt fund is an "associate" of the PE fund could be sufficient to qualify them as a related party of the taxpayer, notwithstanding that the debt fund operates on an independent basis to the private equity fund and provides finance to the taxpayer based on arm's length commercial lending practices.

It is also possible that a provider of debt and a provider of equity to a company may have relationships or associations with a common third party. Such arrangements may include a common provider of trustee services or investment management services. Again, it would provide an onerous compliance burden on the company to investigate and confirm all potentially associations between providers or debt and equity. Similar to the previous example, this burden is unlikely to be discharged given the company's limited access to such information.

AVCAL proposes that any concept of 'related party debt' in the context of the ALDT should assess whether an entity is a 'related party' of the taxpayer rather than an "associate" (or similar) based test.

AVCAL also notes that it is a relatively common feature of mezzanine lending practices that equity type instruments are issued to lenders either as security or as additional returns on the lenders. Generally, such equity type instruments do not give rise to deductible outgoings to the borrower and would lower the cost of borrowing on the

debt lent by the mezzanine lender. The impact of these arrangements is to lower the lower the overall deductible cost of borrowing to the Company.

AVCAL is of the view that mezzanine lenders which take such equity stakes in a borrower (whether by warrants, options, mortgage, preferred or ordinary share capital) should not be regarded as a "related party" because they have also extended debt on an arm's length basis to the same entity. AVCAL proposes that such mezzanine debt should, subject to appropriate conditions to be met, not be regarded as related party debt. AVCAL suggests that appropriate conditions may include a maximum level of equity holding for such lenders and/or a minimum proportion of debt as a component of the total funding provided by the lender.

Question 4.2(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?

Question 4.2(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?

AVCAL's view is that the fundamental design of the ALDT should retain a high degree of flexibility that allows taxpayers to have regard to their own unique facts and circumstances in assessing whether the ALDT is satisfied. The ALDT should remain flexible in its potential application to accommodate differences in funding profiles for different industries and types of taxpayers. For taxpayers whose business can support a higher gearing level beyond these limits, recourse to an improved ALDT should be allowed under an approach that remains flexible in its application, and which therefore requires a degree of subjective analysis.

It is also noted that the existing safe harbour test and the proposed additional safe harbour test are designed to provide certainty of outcome for taxpayers who seek to rely on them. It is important to ensure that the administration of these tests do not put their flexible application at risk.

AVCAL supports an approach under which the legislation does not exhaustively prescribe a list of relevant factors and/or assumptions that an independent lender would or would not consider, or prescribe 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.

AVCAL strongly disagrees with any move to statutorily or arbitrarily exclude certain factors from being available for consideration in the ALDT analysis. It is precisely factors such as intangibles or internally generated goodwill that can be reflected in a taxpayer's cash flow and therefore debt serving capacity, which an independent lender would take into account when assessing an entity's creditworthiness. Furthermore, these are the type of factors considered in credit assessments that the safe harbour test is unable to capture but which the ALDT can.

Discussion Paper Chapter 5: Easing the administrative burden for the ATO

The following sets out AVCAL's response to Chapter 5 of the Board of Taxation's discussion paper.

Consultation Questions

Question 5.1(a): Whether there is uncertainty in determining the arm's length debt amount and, if that is the case, what is the uncertainty related to and how it could be reduced?

Question 5.1(b): Where there is uncertainty in determining the arm's length debt amount, whether there is a need to provide guidance to taxpayers on the relevant factors that would be considered by the Commissioner of Taxation when exercising the override power?

An improved ALDT would perform the function of a 'residual' thin capitalisation test that allows taxpayers to access more commercially optimal levels of debt funding than can be obtained under the more prescriptive safe harbour tests, taking into consideration the facts and circumstances of each taxpayer.

AVCAL's preference would be to maintain an ALDT that retains a high degree of flexibility in its application to accommodate differences in funding profiles for different industries and types of taxpayers and therefore not overly restricted by a list of prescriptive factors that should (or should not) be taken into account.

Under such an approach, there will be a degree of uncertainty in determining the arm's length debt amount. However, as part of normal commercial practice taxpayers will need to undertake documented analysis to support their position in order to achieve a level of certainty (in the same way that transfer pricing positions need to be documented).

In circumstances where a taxpayer has made a substantiated assessment as to their view of a gearing level that satisfies the ALDT, it is reasonable to expect that the Commissioner should provide objective reasons as to why an override power has been exercised and the factors that were taken into consideration. To the extent that public guidance or examples can be provided, this would obviously be helpful in future ALDT assessments.

Question 5.2(a): The rationale for allowing an extension of time for the preparation of the documentation supporting the ALDT and, if the extension is to be given, on what terms and under which circumstances should it be given?

Given the level of analysis and documentation that may be required in order to substantiate the ALDT, AVCAL supports an extension of time for preparation of the ALDT documentation. The extension period should represent a reasonable period of time after the end of the year in which the relevant ALDT analysis is required.

As previously stated, it is preferred that the ALDT is forward looking from the time the debt is established, or from any future re-evaluation point. However, given that the ALDT is only considered when the safe harbour tests are not met, it may be that reliance on the ALDT is not required until a period of time has elapsed (which may be years) after the effective testing date. The timing requirements for preparing the ALDT analysis should allow for this.

Discussion Paper Chapter 6: Eligibility for the arm's length debt test

The following sets out AVCAL's response to Chapter 6 of the Board of Taxation's discussion paper.

Consultation Questions

Question 6.1(a): Whether there should be a limitation on eligibility to access the ALDT and the rationale for it?

AVCAL believes that the ALDT should continue to be available to all taxpayers who seek to support debt levels in excess of the safe harbour tests, having regard to their own particular circumstances. AVCAL does not believe there should be any constraints or limitations imposed on access to the ALDT rules, which is consistent with the underlying policy intent of these provisions, which was to ensure that there exists a flexible alternative to the "one size fits all" safe harbour test.

Question 6.1(b): If a limitation on access to the ALDT is introduced, what principles could be adopted in determining such limitation?

AVCAL does not support the introduction of any limitation or restrictions in respect of the ALDT.

Question 6.1(c): Whether there are better ways of balancing the aims of minimising compliance and administrative costs, protecting the revenue base, and recognition of individual commercial circumstances?

AVCAL recommended above that a new safe harbour test (based on EBITDA) should be introduced to provide an additional mechanism through which taxpayers can access interest deductibility (based on cash flows), whilst at the same time striking an appropriate balance between compliance and administrative costs, protection of the revenue base, and recognition of the sometimes individual and unique circumstances of a particular taxpayer.

If taxpayers want to seek a higher level of gearing by reliance on the ALDT, it is reasonable that the onus should fall on them to document and support that position.

Question 6.1(d): Whether access to the ALDT should be restricted by an advanced ruling or determination system?

A key structural element of the Australian tax system is the self-assessment regime. For that reason, AVCAL does not support the ALDT being restricted only to circumstances where an advance ruling or determination is obtained by a taxpayer seeking to apply those rules. Additionally, AVCAL does not support any mandatory or optional advance thin capitalisation compliance agreements in order to access the ALDT. Where taxpayers seek the highest degree of certainty with respect to the application of the ALDT rules to their individual circumstances, they should be rely on the normal tax rulings system that is available to all taxpayers in respect of the application of the tax law.

Question 6.1(e): If an advance ruling or determination system were to apply, what would be the appropriate instance to obtain an advanced ruling or determination, e.g. an established body, a specially designated independent expert panel, or other options?

AVCAL does not support an advance ruling or determination system.