



PITCHER PARTNERS

ADVISORS PROPRIETARY LIMITED

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The Board of Taxation
c / o The Treasury
Langton Crescent
PARKES ACT 2600

Email: taxboard@treasury.gov.au

Level 19
15 William Street
Melbourne
Victoria 3000

Level 1
80 Monash Drive
Dandenong South
Victoria 3175

Postal Address:
GPO Box 5193
Melbourne Vic 3001
Australia

Tel: +61 3 8610 5000
Fax: +61 3 8610 5999
info@pitcher.com.au
www.pitcher.com.au

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Dear Sir / Ms

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

We welcome the opportunity to make a submission on the Discussion Paper entitled Review of the Thin Capitalisation Arm's Length Debt Test ("the Paper").

Pitcher Partners is one of the largest accounting associations outside the Big Four. Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises - which we refer to as "the middle market" in this submission.

General comments

Whilst the proposed \$2 million debt deduction de minimis threshold under the thin capitalisation rules is welcome news for many taxpayers, it will not prevent the larger taxpayers in the middle market from having to deal with the compliance burden presented by the new rules.

That is, more taxpayers in the middle market will be subject to the thin capitalisation rules if the safe harbour debt to equity ratio is reduced. Taxpayers in the middle market:

1. have less resources available than larger taxpayers to deal with tax compliance issues;
2. make far greater use of debt funding than larger taxpayers;
3. are not able to readily obtain or restructure their debt financing compared to larger taxpayers; and
4. cannot access equity funding as easily as larger taxpayers.

Being able to access the arm's length debt test ['ALDT'] will therefore, be crucial to many middle market taxpayers that are seeking to claim debt deductions - i.e. where they are unable to pass either the revised safe harbour debt amount or worldwide gearing tests.

Accordingly, we would not support any move to restrict the eligibility for the ALDT as contemplated in Chapter 6 of the Paper.

Specific comments

We believe that there needs to be a balance struck between compliance costs and revenue risks for taxpayers in the middle market - i.e. the ALDT rules should recognise that for taxpayers with a turnover below a certain point there is no significant risk of tax being avoided by those taxpayers if they are allowed to use the ALDT rules (especially if they only have external borrowings).

All external borrowings should automatically pass the ALDT

We submit that all middle market taxpayers with external borrowings should be automatically able to access the ALDT - with the definition of a middle market taxpayer being aligned with that used by the Australian Taxation Office ['ATO'].

If the definition of a middle market taxpayer used by the ATO (which regards entities with an annual turnover of up to \$250 million as small to medium enterprises) is too high, then the thresholds for the application of the Taxation of Financial Arrangement rules in Division 230 of the 1997 Tax Act should be used.

ALDT on a consolidated "family group" basis

If a 'carve out' for middle market taxpayers with external debt is unacceptable, then at the very least middle market taxpayers should be allowed to perform the ALDT on a consolidated "family group" basis - with the definition of a "family group" in the Trust Loss rules being used for this purpose.

ALDT should be passed if a transfer pricing analysis has been done

Those middle market taxpayers who have done a transfer pricing analysis for their related party debt should be regarded as passing the ALDT. That is, the benchmarking done for transfer pricing purposes should be acceptable for ALDT purposes as well.

This process would provide middle market taxpayers with the opportunity to leverage off their transfer pricing benchmarking and would reduce the compliance burden of having to perform two types of testing.

Further Details

Additional information on the above (and other) points can be found in the attached Appendix.

Contacts

Should you wish to discuss any aspect of our submission in further detail, please contact me on 03 8610 5503 (theo.sakell@pitcher.com.au).

Yours sincerely



T SAKELL
Executive Director

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Appendix - Specific Comments

Our definition of the middle market

Our specialisation is advising smaller public companies, large family businesses and small to medium enterprises - which we refer to as “the middle market” in this submission.

In terms of defining the middle market in \$ dollar terms, we agree with the classification adopted by the Australian Taxation Office (“ATO”) in its 2013/14 Compliance Program - which regards entities with an annual turnover of up to \$250 million as small to medium enterprises.

Access to finance by taxpayers in the middle market

The following extracts are from a Report produced by the Parliamentary Joint Committee on Corporations and Financial Services in April 2011 entitled ‘Access for Small and Medium Business to Finance’ and highlight the fact that the middle market makes greater use of debt funding and less use of equity funding than larger taxpayers - any move to restrict the deductibility of interest may thus, have a far greater impact on the middle market than on larger taxpayers.

The importance of access to finance for SMEs

1.22 *Small and medium businesses are a fundamental part of Australia's economy. The Australian Bureau of Statistics has calculated that at 30 June 2009 SMEs provided employment for approximately 7.1 million people. For the 2008-09 financial year, SMEs also provided 58% of industry value added; that is, businesses' contribution to the gross domestic product.*

1.23 *The relevance of SMEs to the Australian economy was noted in submissions to the inquiry. For example, Treasury advised that:*

Small and medium sized enterprises (SMEs) make a significant contribution to employment, productivity, and value added in the Australian economy.

1.24 *Several submissions also argued that a strong SME sector is a vital component of a robust economy. Views put to the committee are reflected in ACCI's statement that:*

a healthy small business sector is the key in ensuring the durability and sustainability of private sector-led growth, creating jobs and introducing innovation and productivity growth in the Australian economy.

1.25 *Against this background, the committee was informed that SMEs have limited funding options and place considerable reliance on debt funding. The RBA advised that:*

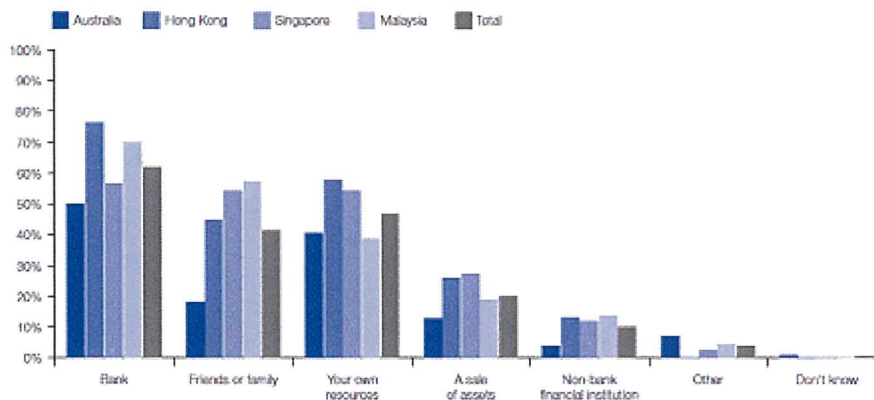
Businesses use a combination of debt and equity to fund their operations. Compared with large companies, smaller businesses tend to make greater use of debt funding and less use of equity funding; the latter is generally limited to the personal capital of the owners. Small businesses rely mainly on loans from banks and other financial institutions for their debt funding, as it is difficult and costly for them to raise funds directly from debt capital markets. Most lending to small businesses is secured against residential property.

1.26 Treasury shared this view, stating that debt funding from banks is essential for SME business:

SMEs fund their activities from a variety of sources, including internal funding, owner equity, venture capital, secured and unsecured intermediated credit, and bank bills. While larger businesses can issue corporate bonds and equity as alternative sources of finance, small businesses' funding requirements tend to be too small to make such issuance cost-effective. As such, bank credit remains an important funding source for SMEs.

1.27 CPA Australia reported that for the Australian businesses surveyed as part of the Asia Pacific Small Business Survey 2010 (the Asia Pacific Survey), 'the most important source of finance was from a bank'. The data provided indicated that for the Australian respondents bank lending was the primary source of funding followed by internal resources.

Figure 1.1: CPA Australia, Asia Pacific Small Business Survey 2010, 'Source of additional funds'



Question 3-4: And from which of the following sources were those 'required additional funds' obtained? (Multiple response) (Australia n=128, Hong Kong n=85, Malaysia n=96, Singapore n=85)

We also note that the Reserve Bank of Australia hosted a small business finance roundtable in May 2012 in order to gain a better understanding of how small businesses are financed. That roundtable noted (inter alia) that small businesses pay more, on average, for debt than both households and larger businesses. This is because smaller businesses are typically viewed as having more volatile revenue streams, make greater use of riskier forms of loan collateral and make more use of unsecured debt products.

In our view the proposed rules risk damaging the middle market - particularly those middle market taxpayers seeking to expand outside Australia where it is difficult to place debt in newly established foreign subsidiaries. That is, debt funding on competitive terms is unlikely to be available at the local level for a newly formed entity and will need to come from the Australian parent.

In short, any rules that will effectively require the middle market to raise equity capital rather than debt will automatically disadvantage the middle market – this is because, as Treasury has recognised, it is far harder for taxpayers in the middle market to raise equity than it is for larger businesses.

The arm's length debt test ['ALDT']

We submit that the best way to reduce the extra compliance costs that will be faced by middle market taxpayers under the revised thin capitalisation rules will be to strike an appropriate balance between compliance costs and revenue risks for these

taxpayers - i.e. the ALDT rules should recognise that for taxpayers with a turnover below a certain point there is no significant risk of tax being avoided by allowing them to use the ALDT rules (especially if they only have external borrowings).

Similarly, the ALDT rules should recognise that there is no real point in requiring taxpayers (especially ones in the middle market with limited resources) to undertake annual testing - the test should only be applied in the year in which a borrowing occurs and should be regarded as being passed until the end of the loan unless there are material changes to its terms.

Definition of external borrowings

We believe that an external borrowing for the purposes of the ALDT should be defined as any sum borrowed from an entity that is not an 'associate' of the debtor - with the definition of an 'associate' in section 318 of the 1936 Tax Act being used for these purposes.

This definition of an 'associate' is already extensively used throughout the 1936 and 1997 Tax Acts, so its use for the purposes of the ALDT rules will ensure that a consistent approach is taken when determining whether a debt is from a related party.

All external borrowings should automatically pass the ALDT

We submit that all middle market taxpayers with external borrowings should be automatically able to access the ALDT - with the definition of a middle market taxpayer being aligned with that used by the ATO.

Such a move would not only benefit those middle market taxpayers that only have external borrowings but would simplify compliance for middle market taxpayers that have both external and internal borrowings - i.e. by enabling the latter group to only have to focus their limited resources on determining if the internal debt passes the ALDT.

If the definition of a middle market taxpayer used by the ATO (which regards entities with an annual turnover of up to \$250 million as small to medium enterprises) is too high, then the thresholds for the application of the Taxation of Financial Arrangement rules in Division 230 of the 1997 Tax Act should be used.

The following entities are (prima facie) excluded from TOFA on the basis of the TOFA thresholds:

- an authorised deposit-taking institution, a securitisation vehicle or a financial sector entity with an aggregated turnover of less than \$20 million;
- a superannuation entity, a managed investment scheme or a similar scheme under a foreign law if the value of the entity's assets is less than \$100 million;
- any other entity (except an individual) that:
 - has an aggregated turnover of less than \$100 million;
 - has assets of less than \$300 million; and
 - has financial assets of less than \$100 million.

ALDT on a consolidated “family group” basis

If a ‘carve out’ for middle market taxpayers with external debt is unacceptable, then at the very least middle market taxpayers should be allowed to perform the ALDT on a consolidated “family group” basis - with the definition of a “family group” in the Trust Loss rules being used for this purpose.

A “family group” under the Trust Loss rules is defined in section 272-90 in Schedule 2F of the 1936 Tax Act and comprises not only the members of the test (or primary) individual’s family but also includes companies, partnerships and trusts:

- that have made an interposed entity election to be part of the family group;
- where certain members of the family group have fixed entitlements (directly or indirectly and for their own benefit) to all of the income and capital of the company, partnership or trust; and
- family trusts with the same test individual in their family trust elections.

Allowing middle market taxpayers to perform the ALDT on a consolidated basis will:

1. not only enable middle market taxpayers to determine what their groups as a whole can borrow; but
2. will recognise the reality faced by most middle market taxpayers that every entity in a middle market group is usually called upon to support a loan from an external party.

ALDT should be passed if a transfer pricing analysis has been done

Those middle market taxpayers who have done a transfer pricing analysis for their related party debt should be regarded as passing the ALDT. That is, as the new transfer pricing rules require any related party debt to be tested against the conditions that might be expected to operate between wholly independent parties, the benchmarking done for transfer pricing purposes should be acceptable for ALDT purposes as well.

This process would provide middle market taxpayers with the opportunity to leverage off their transfer pricing benchmarking and would reduce the compliance burden of having to perform two types of testing.

In other words, harmonising the ALDT and transfer pricing rules will facilitate the administration of the ALDT within the existing procedures for administering the transfer pricing rules.

Guidelines for the application of the ALDT

Given the high level of expense associated with compliance with the ALDT, we submit that it is essential that guidelines are incorporated into the administrative approach taken by the ATO in implementing the ALDT.

We believe that taxpayers in the middle market would be likely to implement the applicable guidelines rather than seek to do their own detailed ALDT analysis in most instances. This would have the dual benefit of keeping compliance costs relatively modest and limiting revenue risk.

At the very least, SMEs / other taxpayers should have the certainty of knowing that they will not be exposed to any amendments if the amounts they have calculated are done in accordance within the guidelines.

We believe that such guidelines would be relatively easy to implement by having the new thin capitalisation rules specifically authorise the ATO to issue Practice Statements having regard to certain factors.

For example, the legislation could authorise the ATO to issue a Practice Statement setting out the parameters for the guidelines by:

- defining a series of loan classes (such as secured and unsecured loans);
- specifying an authorised methodology for each loan class (for example, the Reserve Bank of Australia's indicator lending rate for \$A loans or an equivalent foreign bank for loans in foreign currencies); and
- setting out an approved range within the authorised methodology for each class (for example, plus or minus 200 basis points of the relevant benchmark).

Examples of this type of approach can be found in the service trust guide issued by the ATO.

Provided the guidelines are designed in a way that allows them to be easily understood and applied, we believe that taxpayers in the middle market are likely to choose the applicable guideline rather than doing their own detailed ALDT analysis.