



Australian Government

The Board of Taxation

REVIEW OF THE THIN CAPITALISATION ARM'S LENGTH DEBT TEST

Discussion Paper

the **board** of **taxation**
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the **board** of **taxation**

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Manager
Communications
The Treasury
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FOREWORD

The Board of Taxation has been asked to undertake a review of the arm's length debt test (ALDT) as it applies to the thin capitalisation rules, to make it easier to comply with and administer, and to clarify in what circumstances it should apply.

The ALDT is an alternative approach available for taxpayers to self-assess their thin capitalisation position for a level of debt which is considered to be 'commercial or independent'. The arm's length test focuses on what a business acting at arm's length would borrow and what independent commercial lenders would lend to the business (the policy).

Having regard to the policy, the Board has been charged with consulting on ways to make the arm's length test more effective by reducing compliance costs for business and making it easier for the Australian Taxation Office to administer. The Board has also been asked to consider who should be eligible to access the arm's length test and in what circumstances.

The purpose of this discussion paper is to gather views from stakeholders on the issues raised by the terms of reference of this review. To assist stakeholders, the paper:

- provides background on recent developments regarding the thin capitalisation rules;
- summarises the structure of the thin capitalisation rules and outlines the key features of the arm's length debt test;
- provides some summary statistics on the recent use of the ALDT and brief references to international experiences with thin capitalisation;
- outlines some issues associated with the compliance and administrability of the ALDT; and discusses some issues associated with the eligibility for the ALDT.

Consultation with industry and other affected stakeholders and submissions from the public will play an important role in shaping the Board's recommendations to the Government.



Teresa Dyson
Chair of the Board of Taxation



Elizabeth Jameson
Chair of the Working Group

CHAPTER 1: EXECUTIVE SUMMARY

1.1 On 14 May 2013, the then Deputy Prime Minister and Treasurer and the then Assistant Treasurer and Minister Assisting for Deregulation jointly announced that the Government would ask the Board of Taxation (the Board) to undertake a review of the arm's length debt test¹ (ALDT) as it applies to the thin capitalisation rules, to make it easier to comply with and administer, and to clarify in what circumstances the test should apply.

1.2 On 4 June 2013, the then Assistant Treasurer and Minister Assisting for Deregulation announced the terms of reference for this review. As part of his announcement, the then Assistant Treasurer and Minister Assisting for Deregulation noted that in its current form, the ALDT imposes high compliance costs on taxpayers and can be difficult for the Australian Taxation Office (ATO) to administer.

1.3 The following terms of reference were given to the Board.

TERMS OF REFERENCE

1.4 The Board of Taxation is asked to undertake a review of the thin capitalisation arm's length test contained in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997).

1.5 The arm's length test is intended to provide a carve-out from the thin capitalisation rules² for a level of debt which is considered to be 'commercial or independent'. The arm's length test focuses on what the business acting at arm's length would borrow and what independent commercial lenders would lend to the business (the policy).

1.6 Having regard to the policy, the Board is to consult on ways to make the arm's length test more effective by reducing compliance costs for business and making it easier for the ATO to administer.

1.7 In addition, the Board should consider who should be eligible to access the arm's length test and in what circumstances.

1.8 The Board should consider views put forward and provide its recommendations in a report to the Government by December 2014.

1 The arm's length test for non-Australian deposit institutions (non-ADIs) is referred to as the arm's length debt test. There is a separate arm's length capital amount test for ADIs, which is not the focus of this review.

2 The arm's length test is an alternative to the safe harbour approach in the thin capitalisation rules.

THE REVIEW TEAM

1.9 The Board has appointed a Working Group of its members comprising Elizabeth Jameson (Chair of the Working Group), Teresa Dyson and Keith James to oversee the review. In addition, the Board has asked Mark Goldsmith, a member of its Advisory Panel, to be a member of the Board's Working Group.

1.10 The Working Group is being assisted by members of the Board's Secretariat, the Treasury and the ATO.

1.11 The Board has also received assistance from a panel of senior tax experts, comprising Nick Houseman and of members of its Advisory Panel, comprising Paul Hooper, Anthea McKinnell and Karen Payne. The position and affiliations of the Board's members and Advisory Panel are listed on the Board's website, and Nick Houseman is a partner specialising in Transfer Pricing at PricewaterhouseCoopers.

KEY ISSUES

Consultation

1.12 The Board has conducted targeted preliminary consultations with a range of stakeholders.

Submissions

1.13 The Board invites written submissions to assist with its review. Submissions should address the terms of reference set out in paragraphs 1.5 to 1.9 and the issues and questions outlined in this discussion paper (a full list of questions is at Appendix A), or any matter stakeholders consider relevant to the terms of reference.

1.14 The closing date for submissions is 14 March 2014.

1.15 Submissions can be sent by:

Mail to: The Board of Taxation
 c/The Treasury
 Langton Crescent
 CANBERRA ACT 2600

Facsimile: (02) 6263 2617

Email: taxboard@treasury.gov.au

1.16 Stakeholders making submissions should note that Board members, the review team, and those assisting it, will have access to all submissions. All information (including name and contact details) contained in submissions may be made available to the public on the Board's website unless it is indicated that all or part of the submission is to remain in confidence. Automatically generated confidentiality

statements in emails do not suffice for this purpose. Respondents who would like only part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request for a submission to be made available under the *Freedom of Information Act 1982* (Commonwealth) that is marked 'confidential' will be determined in accordance with that Act.

The Board's report

1.17 The Board will consider the issues raised by stakeholders in their submissions and in consultation meetings. However, the Board's report and its recommendations will reflect the Board's independent judgement.

1.18 The Board has been requested to provide its report to Government by December 2014.

CHAPTER 2: BACKGROUND TO THE REVIEW

THE RALPH REPORT

2.1 In July 1999 the Review of Business Taxation chaired by Mr John Ralph AO completed its report '*A Tax System Redesigned*' (the Ralph Report). The then thin capitalisation rules were examined as part of the Ralph Report.

2.2 The Ralph Report concluded that Australia's thin capitalisation rules were not fully effective at preventing an excessive allocation of debt to the Australian operations of multinationals because they referred only to foreign related party debt and foreign debt covered by a formal guarantee rather than total debt. The provisions did not restrict the proportion of third party debt that could be allocated to the Australian operations.

2.3 To address the above, the Ralph Report recommended that the thin capitalisation rules be strengthened by applying them to the total debt of the Australian operations of a foreign multinational investor, including permanent establishments (that is, branches) operating in Australia.

2.4 The Ralph Report also recommended that the rules be extended to Australian multinational investors with non-portfolio investments or offshore branches, as they could also be in a position to allocate excessive debt to their Australian operations. Concurrent with this recommendation, the Ralph Report recommended that the law be amended so that interest expenses incurred in earning foreign source income were no longer quarantined.

2.5 The Ralph Report noted that if its recommendations were to be adopted, the thin capitalisation rules would be the only restriction on the deductibility of interest where Australian taxpayers borrow to invest in controlled foreign entities. The report noted that compliance costs would be reduced by removing interest expenses from the operation of the quarantining provisions. Taxpayers would no longer be required to determine (by tracing and matching) expenses incurred in earning foreign source income.

2.6 The Ralph Report recommended a two-tier test in relation to the amount of debt on which interest deductions may be claimed. First, deductions would be allowed where the debt-to-equity ratio did not exceed a 'safe harbour' limit, which was proposed to be set at a ratio of 3:1, with equity measured as total shareholders' funds. This increase from the then 2:1 ratio was argued on the ground that third party debt was proposed to now be included in the ratio along with related party debt.

2.7 For Australian multinational investors, if the safe harbour ratio was exceeded, the Ralph Report proposed that interest deductions be disallowed to the extent that gearing of the Australian operations exceeded the arm's length test and 120 per cent of the worldwide gearing of the group.

2.8 The Ralph Report proposed that Australian operations be subject to an arm's length test to determine whether the gearing level could have been borne by an independent party operating under the same terms and conditions, having regard to a number of factors including the worldwide gearing of the associated group, the ability of the Australian operations to service the debt, the nature of the Australian assets, and global industry practices.

2.9 As proposed in the Ralph Report, the worldwide gearing ratio test was to accommodate businesses in Australia that needed equity to expand offshore and would have lower compliance costs for Australian-controlled groups than for foreign multinationals because the Australian groups report their group profits using Australian accounting standards.

2001 THIN CAPITALISATION MEASURES

2.10 In 1999, the then Government agreed to recommendations made in the Ralph Report regarding the strengthening of the thin capitalisation rules. In his press release 074 of 11 November 1999, the then Treasurer detailed the following key features of the new thin capitalisation rules:

- The new thin capitalisation rules would apply to the total debt of the Australian operations of multinational groups (including branches of those groups).
- They would cover inward investment of foreign multinationals and outward investment of Australian-based multinationals.
- They would include a safe harbour set at a ratio of 3:1 debt-to-equity (total shareholders' funds). Interest deductions would be denied to the extent that gearing would exceed the safe harbour ratio.
- Where gearing would exceed the safe harbour ratio, multinationals would not be affected by the rules if they could satisfy the arm's length test (demonstrating that their level of gearing could have been borne by an independent entity).
- Separate rules would apply to financial institutions.
- To facilitate their inclusion in the rules, branches would be required to prepare financial accounts for taxation purposes.

2.11 An exposure draft of the *New Business Tax System (Thin Capitalisation) Bill 2001* was released on 21 February 2001, noting that the measures would apply from 1 July 2001. The corresponding Act received Royal Assent on 1 October 2001.

THIN CAPITALISATION: APPLICATION OF ACCOUNTING STANDARDS

2.12 The Ralph Report considered it appropriate to have regard to accounting principles in the development of taxation legislation. In view of this, the then Government decided that the recognition and valuation of assets, liabilities and equity capital for thin capitalisation purposes would be conducted in accordance with applicable accounting standards (issued by the Australian Accounting Standards Board).

2.13 At the time the thin capitalisation rules commenced in 2001, the relevant accounting standards were the Australian Generally Accepted Accounting Principles (AGAAP). From 1 January 2005, AGAAP were replaced by Australian equivalents to International Financial Reporting Standards (AIFRS).

2.14 On 24 January 2005, the then Treasurer announced that, following the adoption of AIFRS on 1 January 2005, the Government would provide a three-year transitional period to AIFRS for the purposes of the thin capitalisation rules. During the transitional period, taxpayers would be able to undertake their safe harbour calculation using AGAAP as they existed pre-1 January 2005.

2.15 The then Treasurer noted that most taxpayers assess their thin capitalisation position on the basis of the safe harbour test. He also noted that the transition period would provide sufficient time for the Government to examine whether the thin capitalisation rules were appropriate following the adoption of AIFRS.

2.16 In November 2006 the Treasury released a discussion paper, *Thin Capitalisation: Application of Accounting Standards*, the purpose of which was to raise awareness of the interaction between the adoption of AIFRS and the thin capitalisation rules, and to suggest possible responses to the issues identified.

2.17 The discussion paper noted that as a result of the adoption of AIFRS, some entities might have experienced a deterioration of their thin capitalisation position, either through a reduction in the value of assets and/or an increase in liabilities that feed into their thin capitalisation calculations. It also noted that possible changes to the thin capitalisation rules in light of the adoption of AIFRS seemed to fall into the following categories:

- those focused primarily on the safe harbour test (involving departures from AIFRS in the recognition and/or valuation of certain assets, liabilities and equity capital); and
- changes to the ALDT.

2.18 Possible amendments to the ALDT that had been raised with the Treasury at the time included:

- relaxing the requirement that an entity be able to have borrowed the same amount independently on exactly the same terms;
- moving to a solely 'independent lender' test, relying on factors that a commercial lending institution would have regard to, such as credit rating, cash flow (ability to service debt), and security of assets;
- using proxies for arm's length borrowing capacity other than the safe harbour test's net Australian assets (such as interest cover on Australian cash flows);
- extending the period of the test, such that once passed it would not need to be applied again for three to five years or until such time as there was a material change in the circumstances of the entity; and
- amending or removing some of the relevant factors that must be taken into account under the current test (set out in subsections 820-105(3), 820-215(3), 820-315(3) and 820-410(3)) of the ITAA 1997.

2.19 Treasury has advised the Board that, following these consultations, no changes were made to the ALDT. It was considered, in particular, that moving to an 'independent lender' test would compromise the integrity of the thin capitalisation rules.

BUSINESS TAX WORKING GROUP EVALUATION OF THE PROVISIONS

2.20 In June 2012, the previous Government asked the Business Tax Working Group (BTWG) to prioritise consideration of a proposal to reduce the company tax rate accompanied by measures to fully offset the proposal's cost by broadening the tax base.

2.21 On 13 August 2012, the BTWG released a discussion paper on a number of base broadening options, some of which referred to the topic of interest deductibility and thin capitalisation. The discussion paper noted that thin capitalisation rules must strike the right balance between revenue protection and allowing firms to structure their finances as they see fit.

2.22 The discussion paper noted that the gearing levels that the rules allow are higher than the levels employed by purely domestic firms or firms that rely on truly independent financing arrangements. Also, in comparative terms, the Australian rules could be seen as overly generous.

When assessed against other countries' thin capitalisation regimes, the Australian rules could be seen as overly generous. There are flaws with particular rules, including the

arm's length test (particularly when it does not have a firm specific element), which in its current form could allow significant profit shifting to occur.³

2.23 The discussion paper noted that, as a discretionary test, the ALDT is difficult for the ATO to administer. It noted the large information asymmetry that third parties, like the ATO, face when auditing (or potentially auditing) tax calculations that can be based on subjective market and firm specific information, which raised integrity concerns.

2.24 The BTWG identified the following five reform options dealing with interest deductibility and thin capitalisation for business taxpayers:

- Option A.1. Remove the ALDT and reduce safe harbour gearing levels for general entities;
- Option A.2. Reduce safe harbour gearing levels for general entities;
- Option A.3. Reducing safe harbour for financial institutions;
- Option A.4. Cap interest deductions for all business taxpayers (excluding banks); and
- Option A.5. Cap interest deductions for all business taxpayers.

2.25 The BTWG received 83 written submissions in response to the discussion paper, including 62 public submissions and 21 confidential submissions.⁴

2.26 On 1 November 2012, the BTWG submitted its final report. In its report the BTWG noted that it had found it difficult to identify support for measures that would further broaden the business tax base. The BTWG supported the continuation of a consultative approach to business tax reform.

2013-14 BUDGET ANNOUNCEMENTS RELATED TO THIN CAPITALISATION MEASURES

2.27 On 14 May 2013, the then Deputy Prime Minister and Treasurer and the then Assistant Treasurer and Minister Assisting for Deregulation announced a package of measures aimed at protecting the corporate tax base from base erosion and loopholes. The package included measures aimed at addressing tax structures that seek to shift profits by artificially loading debt in Australia.

2.28 The measures included the following changes to the thin capitalisation rules:

- Tightening all safe harbour limits, as follows:

3 Paragraph 98 of the BTWG Discussion Paper.

4 Public submissions are available at <http://www.treasury.gov.au/BTWG>.

- for general entities, the limit to be reduced from 3:1 to 1.5:1 on a debt-to-equity basis (or 75 per cent to 60 per cent on a debt to total asset basis);
 - for non-bank financial entities, the limit to be reduced from 20:1 to 15:1 on a debt-to-equity basis (or 95.24 per cent to 93.75 per cent on a debt to total asset basis);
 - for banks, the capital limit to be increased from 4 per cent to 6 per cent of their risk weighted assets of Australian operations;
 - for outbound investors, the worldwide gearing ratio to be reduced from 120 per cent to 100 per cent (with an equivalent change to the worldwide ratio for banks);
- extending the worldwide gearing test to inbound investors; and
 - increasing the *de minimis* threshold from \$250,000 to \$2 million of debt deductions.

2.29 As part of the measures aimed at addressing tax structures, the then Assistant Treasurer and Minister Assisting for Deregulation also announced his request to the Board to undertake this review of the ALDT.

2.30 Other announced reforms aimed at addressing tax structures referred to the income tax exemption available to Australian companies for their foreign non-portfolio dividend income (section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936)), the removal of the provision that allows a tax deduction for interest expenses incurred in deriving certain foreign exempt income (section 25-90 of the ITAA 1997, and further consideration of the reforms to the controlled foreign company rules, following the analysis by the Organisation for Economic Co-operation and Development (OECD) as part of its work on base erosion and profit shifting.

2.31 Concurrently with his announcement of the measures, the then Assistant Treasurer released a Proposals Paper outlining the changes and inviting comments on a range of issues including those associated with implementing a worldwide gearing test for inbound investors within the thin capitalisation rules.

2.32 The Proposals Paper noted that the Reserve Bank of Australia's Financial Stability Review of March 2013 indicated that business gearing levels have remained at relatively low levels, noting that for listed non-financial corporates, the aggregate gearing (book value debt-to-equity) ratio was estimated to be 54 per cent as at December 2012. It also noted that, according to the Treasury's analysis of the 2011 financial statements for 2,044 ASX listed companies (other than banks), 95 per cent of those companies had debt to equity gearing levels less than 1.5:1.

2.33 The Board understands from the Treasury that 24 submissions were received in response to the Proposal Paper, with most expressing broad support for (or no

opposition to) the proposed changes to the thin capitalisation rules. Stakeholders who opposed the thin capitalisation changes argued that Australia's thin capitalisation rules are already among the most restrictive internationally, with the rules in most other countries only applying to related party debt.

GOVERNMENT ANNOUNCEMENTS WITH RESPECT TO THIN CAPITALISATION

2.34 On 6 November 2013, the Treasurer announced, in a joint media release with the Assistant Treasurer that, with respect to the 2013-14 Budget measures aimed at protecting the corporate tax base from erosion and loopholes, the Government will proceed with the tightening and improving of the thin capitalisation rules as previously announced.

CHAPTER 3: THE ARM'S LENGTH DEBT TEST

3.1 This chapter provides an overview of the policy intent and scope of the thin capitalisation rules, followed by a description of ALDT and data on the use of the ALDT.

3.2 This chapter also provides, as further background, a brief summary of other countries' thin capitalisation rules.

POLICY INTENT AND SCOPE OF THE THIN CAPITALISATION RULES

3.3 As detailed in the Explanatory Memorandum (EM) for the introduction of the *New Business Tax System (Thin Capitalisation) Bill 2001*, the objective of the thin capitalisation rules is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations. The EM explains that the objective of the rules is to prevent multinational entities taking advantage of the differential tax treatment of debt and equity to minimise their Australian tax.

The difference in the income tax treatment of debt compared to equity funding provides an incentive to finance investments using debt rather than equity. While this is not the only consideration, multinational investors have an incentive to allocate a higher proportion of their debt to particular investments and utilise their equity to fund investments outside Australia. It is where this results in a relatively high level of debt funding of the Australian operations that the thin capitalisation regime applies.⁵

3.4 The proportion of debt that can be used to finance the Australian operations is limited by disallowing deductions relating to excessive debt financing.

3.5 The rules establish a gearing threshold beyond which an entity will be subject to the denial of debt deductions. The rules apply to all debt, including related-party debt, third party debt, and both foreign and on-shore debt, to add integrity and fairness to the rules.⁶

3.6 The thin capitalisation rules apply to foreign controlled entities and investors as well as to Australian multinational enterprises with foreign investments in controlled foreign entities or permanent establishments.

5 Paragraph 1.16 of the Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001*.

6 Paragraph 11.7 of the Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001*.

3.7 The thin capitalisation rules apply to:

- foreign entities that carry on business at or through Australian branches;
- foreign entities with direct investments within Australia (for example land and buildings);
- Australian entities that are foreign controlled;
- Australian controllers of foreign entities; and
- Australian entities that carry on business at or through overseas branches.

3.8 Certain associates of the abovementioned entities are also subject to the rules.⁷

3.9 Whether an entity's debt funding is excessive or not is determined by comparing the amount of debt (or equity, in the case of Authorised Deposit-taking Institutions (ADIs)) used to finance the Australian operations with the maximum allowable amount of debt (or minimum equity requirement) specified in the legislation. This comparison is often referred to as an entity's thin capitalisation 'position'.

3.10 Subject to the qualification mentioned below, an entity may calculate its thin capitalisation position by choosing among various tests:

- the 'safe harbour' test;
- the 'arm's length' debt test'; or
- the 'worldwide gearing' test.

3.11 All of these tests are available to Australian resident entities that control a foreign entity or carry on business at or through an overseas branch, as well as Australian associates of such entities (known as 'outward investing' entities). However, the worldwide gearing test is currently not available to foreign controlled Australian resident entities, and foreign entities that carry on business at or through an Australian branch, or have direct investments in Australia (known as 'inward investing' entities).⁸

3.12 The overwhelming majority of entities subject to the thin capitalisation rules adopt the safe harbour test, although an entity may use whichever test provides it with the greatest allowable debt.

3.13 The safe harbour test involves calculating the amount of debt as a ratio to the average value of the entity's Australian assets, with some adjustments for non-financial

7 Paragraph 1.18 of the Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001*.

8 As noted at paragraph 2.26, the announced 2013-14 Budget measures contemplate extending the worldwide gearing test to inbound investors.

entities. This ratio currently cannot exceed three quarters of the average value of the entity's Australian assets – the so-called 3:1 ratio.⁹

3.14 The ALDT involves an analysis of the entity's activities and funding to determine a notional amount that represents what would reasonably be expected to have been the entity's maximum debt funding (or minimum capital funding in the case of ADIs) of its Australian business through the relevant period. It is assumed for the purposes of the ALDT that the entity's Australian operations are financed on arm's length terms.

3.15 The worldwide gearing test allows an Australian entity (other than one controlled by foreign entities) with foreign investments to fund its Australian investments with gearing up to 120 per cent of the gearing of the worldwide group that it controls.¹⁰

THE ARM'S LENGTH DEBT TEST

3.16 Taxpayers can use the ALDT where they fail the safe harbour test but their gearing could otherwise be commercially justifiable.¹¹ The point of the test is to examine the circumstances of the taxpayer to determine whether the Australian operations, when viewed independently from any other operations that the entity or its associates had during the period, could have been undertaken with the actual amount of debt used by the taxpayer on an arm's length basis.

3.17 The test is likely to be of most use in those industries where it is common practice to operate with debt to equity ratios that are higher than the available safe harbour limits. With the tightening of all safe harbour limits, this test may therefore be expected to be utilised by a greater number of taxpayers and accordingly have greater significance in determining deduction limits.

3.18 The objective of the analysis is to establish the notional amount of debt that the entity would reasonably be expected to borrow, and the amount a commercial independent lender would reasonably be expected to provide under arm's length conditions. More specifically, the arm's length debt amount is the notional or hypothetical debt capital amount that, having regard to certain 'factual assumptions' and 'relevant factors', would satisfy the following two elements:

- the amount of 'debt capital' that an entity would reasonably be expected to have borrowed throughout the income year that would give rise to debt deductions and would be attributable to the identified Australian business (the 'borrower element'); and

9 As per the announced 2013-14 Budget measures, the ratio is to be reduced from 3:1 to 1.5:1 on a debt-to-equity basis (or 75 per cent to 60 per cent on a debt to total asset basis).

10 As per the 2013-14 Budget measures, the worldwide gearing ratio is to be reduced to 100 per cent.

11 As noted at paragraph 3.10 of this discussion paper, an entity may calculate its thin capitalisation position by choosing among the various tests. An entity is not required to apply the safe harbour test before applying the ALDT.

- the amount of 'debt capital' that an independent commercial lending institution would reasonably be expected to have lent to the entity under terms and conditions that would be reasonably expected had the parties been dealing with each other at arm's length (the 'commercial lender element').

3.19 The legislation requires that the arm's length debt amount must satisfy both the borrower element and the commercial element. ATO Taxation Ruling TR 2003/1 *Income Tax: thin capitalisation – applying the arm's length debt test* (TR 2003/1) notes that it is possible that the answer to each question may result in two different figures. Where this is the case, TR 2003/1 notes that the logical conclusion would be that the lesser of the two figures is the arm's length debt amount:

It is possible that the answer to each question may result in two different figures. However, the legislation requires that the arm's length debt amount must satisfy both questions. While the legislation does not specifically address this situation, logically it follows that it is only the lesser of the two amounts that can satisfy both questions. Consequently, in such circumstances the arm's length debt amount is the lesser of the two figures.¹²

3.20 As mentioned earlier, the analysis involves a consideration of factors that an entity would consider when arranging finance for its business 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.

Factual assumptions

3.21 The factual assumptions are the basis on which the arm's length analysis must be conducted. Their parameters create a scenario that would exist if the entity carried on only Australian business, with its assets and liabilities during that year solely comprised of those attributable to the Australian business, and had funded its Australian operations without financial or credit support from its associates.

3.22 The factual assumptions include some conditions that actually exist during the income year and some conditions that replace what actually happened during that period.

3.23 The Australian operations are in general identified by reference to the assets that the entity uses or has available for deriving its income other than through foreign subsidiaries or branches.

3.24 The factual assumptions are, broadly, that:

- the entity's only commercial activities are those of its Australian business (Australian business has a wide meaning); and

12 Paragraph 24 of TR 2003/1.

- the entity's Australian business is independent of any guarantee, security or other support provided by any of its associates or by the use of the assets that are attributable to any overseas permanent establishments.

Relevant factors

3.25 Certain factors must be taken into account when undertaking the analysis of whether or not an amount is an arm's length debt amount. These factors are outlined below.

3.26 The relevant factors are those that would be considered by a prudent independent party contemplating borrowing the notional amount on the same terms that were actually made, and those a prudent independent lender would consider when contemplating providing the debt on those same terms.

3.27 All the factors must be taken into account and must be considered in the context of the above assumptions. The factors should not be considered in isolation from each other and some may not be relevant for a particular entity. The weight given to each factor in the analysis of a particular entity may vary, depending on the facts and circumstances of each case.

3.28 The factors are:

- The functions the entity performed, the assets used and the risks it assumed in relation to its Australian business throughout the year.
- The terms and conditions of loans (such as interest rate, repayment amount and the duration of the loan) the entity actually had in relation to its Australian business throughout the year.
- The nature of, and title to, any of the entity's assets attributable to the Australian business that were available to the entity to provide as security for the loans throughout the year.
- The purpose of entering into the loan arrangements in relation to the Australian business throughout the year.
- The entity's capacity to repay both the interest and principal components of the debt, in addition to all its other liabilities, in relation to its Australian business throughout the year.
- The entity's profitability and the return on its capital in relation to the Australian business, whether during that year or at any other time.
- The debt-to-equity ratio of the entity, of the entity in relation to its Australian business, and to each of the entity's associate entities that engage in commercial activities similar to the Australian business.

- The commercial practices adopted by independent parties dealing with each other at arm's length in the industry in which the entity operated its Australian business throughout the year, whether in Australia or in comparable markets elsewhere.
- The general state of the Australian economy throughout the year.
- All of the above factors that existed when the entity previously entered into a scheme that gave rise to an actual debt interest attributable to the Australian business that remained on issue throughout the year.

3.29 The legislation makes provision for additional factors to be prescribed by regulation. To date no additional factors have been prescribed.

Commissioner's power

3.30 The Commissioner may substitute an alternative view of the arm's length debt amount if the Commissioner considers that the specified assumptions and relevant factors have not been properly taken into account.

USE OF THE ARM'S LENGTH DEBT TEST

3.31 The Board has received data prepared by the ATO related to the use of the ALDT by non-ADI general investing entities. The figures are based on the same data set used in costing changes to the thin capitalisation rules that were announced in the 2013-14 Budget.

3.32 For the 2011 income year, the ALDT was used by 55 non-ADI general investing entities, with a combined total of interest deductions of \$1,860.6 million.¹³ This comprised:

- 35 inward investing entities, with interest deductions of \$1,245.5 million; and
- 20 outward investing entities, with interest deductions of \$615.1 million.

3.33 The ATO has also advised that for the 2011 income year, 480 non-ADI general investing entities had a total of debt deductions disallowed of \$839.4 million under the safe harbour or worldwide gearing tests. This comprised:

- 315 inward investing entities, with debt deductions disallowed of \$338.9 million; and
- 165 outward investing entities, with debt deductions disallowed of \$500.5 million.

13 This figure is the total gross interest claimed as a deduction, including the interest payments that would have exceeded the safe harbour or worldwide gearing tests. The majority of deductions corresponded to the electricity, gas, water and waste services sector for inward investing entities and to the construction sector for outward investing entities.

3.34 Increasing the de minimis threshold, as per the rules announced in the 2013-14 Budget, is expected to lead to around 1,200 taxpayers being excluded from the application of the thin capitalisation rules (out of 2,500 taxpayers currently subject to the application of the rules).

3.35 Finally, the ATO estimates that up to 330 general entities would likely have debt deductions denied under the rules announced in the 2013-14 Budget, comprising:

- 185 inward investing general entities with estimated total debt deductions of \$3,734.2 million; and
- 145 outward investing general entities, with estimated total debt deductions of \$5,048.1 million.

3.36 The ATO notes that an unknown number of the above entities are likely to switch to the use of the ALDT in response to the changes to the thin capitalisation rules. As noted at paragraph 3.17, with the tightening of all safe harbour limits, the ALDT is expected to be utilised by a greater number of taxpayers and accordingly have greater significance in determining deduction limits.

INTERNATIONAL EXPERIENCES WITH THIN CAPITALISATION RULES

3.37 Thin capitalisation regimes as applied in different jurisdictions use arm's length approaches, ratio approaches, or both. Any approach can apply only to related party debt, or to both related and third party debt of an entity ('total debt'). Also an approach can apply only to domestic (resident) entities controlled by foreign (non-resident) entities ('inbound investment') or to all multinationals including domestic entities controlling foreign entities ('outbound investment'). In some countries, thin capitalisation rules are also applied to debts solely between domestic entities.

3.38 Some countries' thin capitalisation rules are a subset of their transfer pricing rules (for example, the United Kingdom), while others (for example, Australia) have standalone thin capitalisation rules, even where they adopt an arm's length approach in both their thin capitalisation and transfer pricing rules.

3.39 A typical arm's length approach requires an evaluation of each loan agreement against the conditions (whether prescribed by legislation; administrative guidance or other form of international guidelines) which commercially independent lenders and borrowers acting only in their own interests would be expected to arrive at in a loan agreement. It is therefore a tailored, case-by-case, approach that aims for tax consequences to follow economic reality.

3.40 The ratio approach aims for certainty and simplicity, reducing compliance costs. It disallows debt deductions above a 'safe harbour' threshold. The threshold can be, for example, a ratio of equity to debt (either related and third party debt, or only related party debt); a ratio of the amount of interest payable to the amount of income out of

which that interest is paid, like operating profit or a measure of cash flow (for example earnings before interest, tax, depreciation and amortisation (EBITDA)); or a comparison of a domestic subsidiary's percentage of debt funding to the overall level of debt funding of its worldwide group.

3.41 Some countries, like Australia, have enacted a ratio approach but have added an arm's length test for amounts in excess of the ratio's safe harbour (a combined approach).

3.42 The Action Plan on Base Erosion and Profit Shifting (BEPS) released by the OECD on 19 July 2013 included an action to '*Limit base erosion via interest deductions and other financial arrangements*' (Action Item 4). Recommendations regarding the design of domestic rules are due by September 2015. This work will include:

- Recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related party and third party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations.
- The work will also include changes to Transfer Pricing Guidelines, which are due by December 2015, and which will be co-ordinated with the work on hybrids and controlled foreign company rules.

3.43 The Board considers that the OECD's work on Action Item 4 should not delay this Review, which is focussed on examining ways to make the existing arm's length debt test more effective, as well as reviewing eligibility for the test.

New Zealand

3.44 New Zealand's thin capitalisation rules apply to both inbound and outbound investment to the extent that New Zealand resident entities control or have income interests in certain foreign entities (controlled foreign companies and certain foreign investment funds). The rules do not include an express arm's length test.

3.45 New Zealand has taken a predominantly ratio approach that is calculated in proportion to total debt (that does not include interest-free debt). It mandates that a domestic entity cannot claim debt deductions for inbound debt investment to the extent that the ratio of interest bearing debt to assets of the entity's New Zealand group exceeds the greater of:

- 60 per cent (essentially 1.5:1 debt to equity/other liabilities); or
- 110 per cent of the ratio of debt to assets of the entity's worldwide group.

3.46 For outbound investment, the safe harbour threshold is 75 per cent New Zealand group debt to assets (ignoring investments in foreign equity) and 110 per cent of the worldwide percentage.

3.47 Certain low asset New Zealand multinational groups with a high level of arm's length debt may be able to use a test based on a ratio of net interest expense to pre-tax cash flows, rather than on a debt-to-asset ratio

United Kingdom

3.48 As noted above, the United Kingdom's thin capitalisation rules are a subset of its transfer pricing rules. Therefore, they apply only to, broadly speaking, related party debt (including loans from connected parties, guaranteed third party loans and loans where the parties are 'acting together').

3.49 Detailed guidance is given so that entities can self-assess their 'true, arm's length borrowing capability, ignoring any support...from connected parties apart from their own subsidiaries'.¹⁴ The guidance states: 'it is essential to consider all the terms and conditions of the lending, not just the narrow concerns of amount and rate. The arm's length approach assumes that borrowing will be on a sustainable basis, so that the business must be able to trade, invest and meet its other obligations as well as servicing the debt. The consideration is not just what it could have borrowed, but what it would have borrowed.'¹⁵

3.50 To reduce the need to undertake an arm's length analysis for each yearly tax return, taxpayers can enter into Advance Thin Capitalisation Agreements (ATCA) with HM Revenue & Customs (HMRC) which provide taxpayers with certainty around their intra-group funding arrangements. The arrangements agreed upon in an ATCA, such as maximum amount of debt to be entered into and maximum interest rates to be paid, typically remain in place for between three to five years, depending on the circumstances. Five years is the maximum period for which HMRC considers it reasonable to assume that the agreed method for calculating an arm's length amount remains appropriate.

3.51 The thin capitalisation position is generally only considered at the time at which the loan is entered into. Therefore, the real benefit of an ATCA is the certainty that it gives rather than a reduction in compliance costs. In the absence of an ATCA, the borrower would self-assess their thin capitalisation position. The ATCA will contain conditions that the borrower will need to monitor. If the conditions are not met, the ATCA could cease to have effect.

14 HM Revenue & Customs INTM571015 - Thin capitalisation: practical guidance - introduction: What is thin capitalisation? Retrieved from: <http://www.hmrc.gov.uk/manuals/intmanual/intm571015.htm>.

15 HM Revenue & Customs INTM571015 - Thin capitalisation: practical guidance - introduction: What is thin capitalisation? Retrieved from: <http://www.hmrc.gov.uk/manuals/intmanual/intm571015.htm>.

3.52 The United Kingdom's Finance Act 2004 extended its transfer pricing rules that cover thin capitalisation so as to apply to loans between domestic entities. The United Kingdom amended its thin capitalisation rules along with other European Union countries in response to the European Court of Justice's ruling in the 2002 Lankhorst case that Germany's thin capitalisation rules at the time breached the freedom of establishment provisions of the European Community Treaty, as they did not apply to loans between domestic entities.

3.53 For UK-UK domestic transactions, the disadvantaged party (that is the party that has overstated its profits/understated its losses) can claim a compensating adjustment in respect of any transfer pricing adjustment to the advantaged party's results.

United States of America

3.54 The United States' thin capitalisation rules, termed 'earnings stripping' rules, target excessive deductible payments of interest paid by a more than 50 per cent foreign-owned United States of America (US) corporation to both related parties resident abroad and unrelated parties in certain circumstances. They apply when the interest paid is tax exempt (or partially tax exempt) in the hands of the related entity or, if the interest is paid to a non-related entity, if it is not subject to a gross basis income tax and the guarantor is a foreign person or a tax exempt entity. The US rules do not apply to outbound investment.

3.55 If interest is paid to persons described in the previous paragraph and the payer corporation's debt-to-equity ratio exceeds 1.5: 1 and its net interest expense exceeds 50 per cent of its adjusted taxable income, no deduction is allowed for interest paid in excess of 50 per cent of its adjusted taxable income. Excess interest may be carried forward indefinitely and deducted against future taxable income.

3.56 The Obama administration is proposing to eliminate the 1.5:1 debt-to-equity safe harbour for 'inverted' ('expatriated') US entities, and reducing the 50 per cent adjusted taxable income threshold to 25 per cent. This effectively means that interest paid to an expatriated entity by its related US entities will be deductible up to 25 per cent of EBITDA. The carry-forward of excess interest will be limited to ten years.¹⁶

- Inversions are restructures of US-based multinational corporations in which a US parent corporation is replaced by a new foreign head corporation typically located in a low- or no-tax country, leaving subsidiaries in the US.

3.57 The Obama Administration's proposal responds to a finding of a 2007 US Treasury report of strong evidence of income-stripping by expatriated entities.¹⁷

16 US Treasury. General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals. April 2013, p.53. Retrieved from <http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf>, October 2013.

17 US Treasury. Report to the Congress on Earnings Stripping, Transfer Pricing and Income Tax Treaties. November 2007.

CHAPTER 4: REDUCTION OF COMPLIANCE COSTS FOR TAXPAYERS

4.1 The terms of reference ask the Board to consult on ways to make the ALDT more effective by reducing compliance costs for business and making it easier for the ATO to administer.

4.2 This Chapter discusses issues associated with compliance costs for businesses and seeks feedback on potential options for reducing those compliance costs. For clarity of exposition, issues associated with the administrability of the ALDT are discussed in Chapter 5. Nevertheless, the Board recognises that there are a number of issues that could raise compliance costs for business and at the same time present administrative difficulties for the ATO. Therefore, the breakdown in their discussion by Chapters is somewhat arbitrary.

4.3 To provide further context to the discussion of compliance and administrative issues, a preliminary discussion of the advantages and disadvantages of different types of thin capitalisation rules is presented first in this Chapter.

PRELIMINARY CONSIDERATIONS

4.4 As noted at paragraph 2.21, the thin capitalisation rules must strike the right balance between revenue protection and allowing firms to structure their finances as they see fit.

4.5 A key advantage of the safe harbour rules is that they provide certainty and reduce compliance costs for businesses. On the other hand, a disadvantage of safe harbour rules is that they may not reflect the economic circumstances of particular industries or businesses that operate with higher ratios than those allowed by the safe harbour rules. They may also distort behaviour by promoting excessive use of debt up to the limit allowed by the safe harbour rules.

4.6 The ALDT is the most appropriate method for assessing whether the Australian operations of a multinational entity are sufficiently capitalised.¹⁸ However, the ALDT, by its nature, imposes greater compliance costs for businesses and ATO administration costs. The OECD has commented on the use of an arm's length approach as a feature of thin capitalisation regimes as follows:

The disadvantage of utilising an arm's length approach is its large resource and skill requirements. In order to apply the arm's length approach, the tax auditor needs to

18 Paragraph 11.11 of the Explanatory Memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001*.

understand the processes third party lenders use to determine the maximum amount they would lend to a specific taxpayer. Tax authorities need to have expertise to step into the role of the third party lender and establish the specific characteristics of the group affiliate to determine an appropriate amount of debt.¹⁹

4.7 Applying the ALDT requires both a functional and creditworthiness analysis. As discussed further in this Chapter and in the next one dealing with the administrative costs of the ALDT, there is some degree of subjectivity in applying these analyses. Consequently, there are no guarantees that the conclusions reached by taxpayers and the ATO will necessarily align.

OPTIONS TO REDUCE COMPLIANCE COSTS

4.8 A number of options to reduce compliance costs have been suggested to the Board through preliminary consultations. They are listed below in this section but are not meant to cover all potential suggestions. Stakeholders are invited to comment on these suggestions and/or put forward any other suggestions they may have that would assist in reducing compliance costs while at the same time preserving the integrity of the thin capitalisation rules.

The need for annual testing

4.9 A number of stakeholders have suggested 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). Apart from the obvious compliance burden this requirement creates, it has been suggested that it adds to the artificiality of the test and its difficulties in administration because of the need to apply a set of criteria at a different point in time to when a truly arm's length lender would assess the lending arrangements – being at the time of making the loan and when there are material changes.

4.10 Some stakeholders have argued that taxpayers should not be required to undertake detailed annual testing. It has been suggested that 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). 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.

Retrospective versus prospective focus of the ALDT

4.11 Related to the above, some stakeholders have commented on the retrospective focus of the ALDT and the fiction it creates when compared to the position of an arm's

19 Thin capitalisation legislation, a background paper for country tax administrators, initial draft as of August 2012, at http://www.oecd.org/ctp/tax-global/5.%20Thin_Capitalization_Background.pdf.

length commercial agreement, which is forward looking. Stakeholders have noted that this could be particularly problematic in circumstances where there are start-up businesses or subsequent changes in economic conditions

4.12 Stakeholders have raised whether the factual assumptions and relevant factors could be reviewed so that the assumptions and factors are prospectively focussed rather than retrospectively to better reflect the relevant economic conditions affecting the Australian operations.

4.13 It has been suggested that 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.

Additional safe harbour tests based on earnings

4.14 Some stakeholders have suggested introducing an additional safe harbour test based on earnings rather than assets (such as the EBITDA test used for related party debt in the US). It is argued that this additional safe harbour test would be of particular assistance to service entities with internally generated goodwill, reducing their need to rely on the ALDT.

4.15 Placing a cap on the deductibility of interest by limiting the net interest expense to a set percentage of EBITDA for all taxpayers, excluding banks, was an option raised in the context of the BTWG discussion paper (in a context where the thin capitalisation rules would be removed from the domestic law).

4.16 While the proposal for an additional safe harbour test based on EBITDA is different from the option included in the BTWG discussion paper, feedback obtained by the BTWG on its options for discussion assist in understanding potential implications of such a proposal.

4.17 Commenting on the BTWG options, some stakeholders noted that an EBITDA test would be problematic for cyclical industries, such as mining, as it would lead to lower deductions in difficult times, which may exaggerate the impacts of any downturn in the business cycle. Others noted that an EBITDA benchmark would be particularly problematic for industries where there is a long lead time between incurring the interest expense and revenue streams, such as in greenfield infrastructure projects, or in start-up businesses.

4.18 Other problems identified by stakeholders with an EBITDA test would be lack of certainty and the inability of an entity to manage its thin capitalisation position as it would be exposed on a year to year basis to the impact of abnormal profit and loss impacts, such as adverse foreign exchange movements or one-off asset impairments.

4.19 Stakeholders have also suggested that in order to reduce the need to rely on the ALDT, additional (potentially industry based) safe harbours via administrative

guidance where the risk to revenue is low may be considered, as that would be an option easier to implement and more flexible in application.

Simplify the ALDT when there is no related party debt

4.20 Some stakeholders have argued that where the relevant debt interest is in fact debt that has been borrowed and lent between arm's length parties and not between related parties, the potential integrity concerns that arise may well be different from circumstances where the debt arrangements exist between related parties.

4.21 These stakeholders have argued that in these circumstances the opportunity to manipulate the level of debt or the terms of the debt would be otherwise 'balanced' or 'commercially constrained' as the parties are at arm's length negotiating on commercial terms. The integrity concerns may therefore be expected to be limited to the existence of related party or parent guarantees and the terms of any back to back guarantees or indemnities.

4.22 Accordingly, these stakeholders suggested that the ALDT as applied in these circumstances should focus on a more limited range of integrity concerns. Where the relevant debt interest is in fact debt that has been borrowed from a commercial or third party lender, stakeholders have suggested that the amount borrowed should be accepted as an arm's length debt amount, subject to specified qualifications or limitations, for example, that the circumstances do not otherwise suggest 'back to back' arrangements.

4.23 Conversely, where the relevant debt interest is in fact debt that has been borrowed and lent between related parties, the full ALDT analysis should be undertaken.

4.24 The question arises whether the above suggestion would address the integrity concerns that led to the extension of the thin capitalisation rules to the total debt of the Australian operations.

4.25 Some stakeholders have also noted that there may be some circumstances where the fact that an entity is a 'shareholder' or an equity interest holder is sufficient to qualify them as a related party so that 'extended' integrity tests should apply in determining the arm's length debt amount. As the ITAA 1936 and the ITAA 1997 are primarily concerned with parties that are 'associates', as defined, it was suggested that the relevant inquiry should be to determine the level of 'control' that exists between one party and another (as prevalent in the accounting standards).

Allowing credit support from related parties

4.26 One stakeholder suggested that the ALDT should allow property groups to recognise the financial strength of other related Australian entities.

4.27 The stakeholder noted that consolidated corporate tax groups are treated as a single entity and therefore, any 'credit support' provided by their subsidiary companies is disregarded for the purposes of applying the ALDT.

4.28 In contrast, credit support is not disregarded in property groups that use either a staple structure or a holding structure with subsidiary trusts, where a third party financier takes security over all of the assets of the group.

4.29 It may be the case that credit support can be disregarded in particular circumstances, when they correspond to ordinary commercial dealings and do not represent an integrity concern. Consideration may need to be taken in this context to the applicability of consolidation principles.

Facilitate advanced thin capitalisation agreements

4.30 Some stakeholders have suggested considering the option of entering into advanced thin capitalisation agreements with the ATO, similar to those applying in the UK (as summarised in Chapter 3).

4.31 While advanced thin capitalisation agreements may assist in reducing uncertainties and compliance costs, they may imply an additional administrative burden for the ATO, which will need to ensure that it has the required staff and skills to implement them in a timely fashion.

Exemption for certain special purpose entities

4.32 As part of the preliminary feedback received by the Board on the operation of the ALDT, some stakeholders noted that the Interpretative Decision issued by the ATO relating to the exemption from the thin capitalisation rules for certain special purpose entities²⁰ (ATO ID 2012/31) had the effect of unduly restricting access to the exemption for a range of securitisation vehicles that are generally either fully, or almost fully, funded by third party debt and on-lent on back to back terms. It was argued that these structures are not tax driven and present no tax advantage, but are there to provide a liquidity mechanism to the debt providers and can be particularly useful in facilitating the financing of infrastructure projects.

4.33 The Interpretative Decision was withdrawn on 9 May 2013. Whilst it was in place there was additional pressure put on the ALDT as the key fall-back test to address the needs of projects' sponsors and the banks who lend to those projects which were exposed to the after tax cash flow of those projects.

4.34 The question arises whether there is a need to provide further legislative or administrative guidance regarding the exemption from the thin capitalisation rules for certain special purpose entities.

20 As per section 820-39 of the ITAA 1997.

Q 4.1 Issues/Questions

The Board seeks stakeholder comments on suggested options to reduce compliance costs of the ALDT, including:

- (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;
- (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;
- (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;
- (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;
- (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;
- (f) whether credit support from related parties could be recognised in particular circumstances when they correspond to ordinary commercial dealings and do not represent integrity concerns, and how to determine those circumstances;
- (g) the facilitation of advance thin capitalisation agreements similar to those applying in the UK;
- (h) whether there is a need to provide further legislative or administrative guidance regarding the exemption from the thin capitalisation rules for certain special purpose entities; and
- (i) any other suggestions stakeholders may have drawing on experiences from other countries, for example, Canada, that would assist in reducing compliance costs while at the same time preserving the integrity of the thin capitalisation rules.

ISSUES ARISING REGARDING COMPLIANCE WITH THE ALDT

4.35 This section deals with a number of potential compliance issues with the ALDT that have been identified by the ATO. Feedback is sought from stakeholders on whether addressing these issues would assist in reducing uncertainty and compliance costs for taxpayers. It is not meant to be an exclusive or comprehensive list of potential compliance issues for discussion. Consequently, stakeholders are invited to submit their comments on any issues that are relevant to them.

Practical limitations of the separate borrower and lender tests

4.36 Taxpayers that use the ALDT are required to consider the test from both a borrower and a lender perspective. The borrower test has regard to the debt capital that the Australian business (as distinct from the Australian entity) would reasonably be expected to have throughout an income year. This typically requires a qualitative and quantitative analysis of the entity and comparable entities. However, in many cases, the key information sources readily available are those of a quantitative nature (for example financial ratio analysis of comparable companies) which drive the conclusion reached.

4.37 The lender test has regard to the debt capital that commercial lending institutions dealing at arm's length would reasonably be expected to provide to the Australian business on arm's length terms and conditions. TR 2003/1 indicates that relevant covenants of comparable transactions may be an appropriate starting point for this analysis.²¹

4.38 Based on publicly available information (usually contained in audited annual or financial reports), it is usually not possible for the ATO to determine whether the borrower's perspective or the lender's perspective determines the actual amount borrowed, that is was the borrower interested in borrowing a larger amount and did not receive it from the lender; or was the lender willing to lend a higher amount but the borrower was not willing to borrow a higher amount.

4.39 In practice, the actual borrowed amount is observable and commonly relied upon as a reference point (albeit the reference point will need to reflect the factual assumptions and relevant factors required to be taken into consideration) to determine the arm's length debt amount. Arguably, it could be inferred that the debt capital actually drawn down by the borrower and disclosed in the financial statements reflects a debt capital level that the lender is willing to provide and the borrower is comfortable in borrowing (subject to the relevant factual assumptions and relevant factors).

4.40 However, the adoption of such a practical approach highlights the challenges imposed in complying with the dual requirements of the ALDT.

21 Refer to paragraph 133 of TR 2003/1.

Assessment of what a borrower would be reasonably expected to have borrowed

4.41 As discussed at Chapter 3, the arm's length debt amount is the amount that satisfies two conditions: the notional amount of debt that the entity would reasonably be expected to borrow, and the amount a commercial independent lender would reasonably be expected to provide, under arm's length conditions. Where those amounts differ, it is recognised that it is only the lesser amount of notional debt that can satisfy the test. However, difficulties in applying the elements of the test arise because:

- the debt capital an entity 'would reasonably be expected to have', when assessed against the relevant factors, on one view becomes a subjective rather than objective assessment; and
- what a commercial independent lender would reasonably be expected to lend, on one view does not provide the relevant objectivity in determining what a borrower would borrow given the different commercial objectives of the borrower and lender.

4.42 It is difficult to determine the amount that an entity would reasonably be expected to 'borrow' compared to what the entity 'could' borrow given the lack of weighting of the relevant factors. While factors such as the debt/equity ratio, commercial lending practices within the relevant industry and the financing of commercial non-Australian business may provide some objectivity, those factors need to be assessed against assets available as security and the capacity of the entity to meet its debts. Where security and cash flows to meet debts exist, it is difficult to argue that lending practices in that industry, debt/equity ratios and the way non-Australian assets are financed should outweigh those other factors. This does not lead to the determination of the amount that the borrower 'would' borrow but, rather, the amount that the borrower 'could' borrow.

4.43 The lender element of the ALDT does not assist in providing objectivity as to the amount the borrower 'would' reasonably be expected to borrow. The lender's objective is to profit from a lending transaction. Where cash flows exist and assets are available as security against that borrowing, a lender will lend and potentially offer to lend more than a borrower would reasonably be expected to borrow. Any perceived risk of default by the borrower may require the lender to be compensated by a return for that risk. From the perspective of the lender, the relevant assessment is the amount the borrower 'could' borrow.

4.44 The ATO has noted that this outcome can provide opportunities to allocate a disproportionate amount of debt to Australia when structuring related party borrowing arrangements.

4.45 One case identified by the ATO involved an entity wholly owned by a foreign shareholder with nominal amounts of equity capital issued and a balance sheet predominantly funded by shareholder debt. Given the entity had quality assets and

secure cash flows and generated a high rate of return on nominal equity, the ATO found it difficult to argue that there was an excessive level of borrowing even though the entity had higher debt to equity ratios compared to industry peers.

Internally generated goodwill and borrowing capacity

4.46 The ATO has noted uncertainty around the reliance that a lender would place on certain taxpayer assets such as internally generated goodwill, given that neither the accounting standards nor the thin capitalisation rules allow their recognition.

4.47 In particular, the ATO has queried whether the non-recognition of internally generated goodwill would materially impact the amount an independent commercial lender would be willing to lend to a multinational entity. For example, in certain cases the ATO has considered that the economic value of a taxpayer's intangible assets, including any internally generated goodwill, could be reflected through other aspects of the taxpayer's business (for instance, revenues and profit) such that an appropriate arm's length debt amount can still be determined.

Identification of the relevant Australian business

4.48 The factual assumptions require the identification of the relevant Australian business (assets, liabilities, profits, cash flows and risks assumed).

4.49 The ATO has noted that where the entity's actual business includes significant offshore activities or significant onshore or offshore debt or equity holdings in associates or affiliates (all of which are required to be excised under the factual assumptions), the attribution of amounts to commercial activities, assets and liabilities of the 'Australian business' can lack precision or can be arbitrary.

4.50 In particular, the difficulties in tracing debt liabilities and assets can create uncertainty in how those amounts are to be attributed to the Australian business, how they are valued and the role they play in determining the arm's length debt amount. The tracing exercise is further complicated when the financial data may not have been subject to independent audit scrutiny or accurate application of accounting standards or is hampered by lack of access to the relevant information.

4.51 Additionally, there can also be practical limitations in reconstructing the 'Australian business' financials due to the fact that:

- There is no corporate law requirement that certain foreign subsidiaries of an outward investing entity lodge financial statements.
- Where there are many 'non-Australian business' subsidiaries in the global group, access to internal financials and/or entity-specific management accounts to verify the appropriateness and accuracy of the 'Australian business' financials may be difficult for the ATO, and equally, taxpayers.

- Accurate reconstruction can be time consuming and imprecise due to the fact that detailed knowledge of the taxpayer's business and financial statements is needed.

Attributing intangibles to the Australian business of a multinational company

4.52 Other questions arise in relation to intangibles, particularly what role they play in determining the notional debt amount, and to what extent the assets are required to be excised from the stand-alone Australian business if the entity has multinational businesses.

4.53 As an example, an Australian company has expanded its manufacturing operations overseas and now 70 per cent of its manufacturing activities take place in China and the revenue from distribution chains in China comprises 40 per cent of the total revenue for the group. A strong strategic focus on managing the brand and customer relationships has led to improvements in the revenue base of the company. Following its acquisition by a foreign company, the book value of its intangible assets, comprising customer relationships, brand name and patents, increases by 50 per cent.

4.54 Questions that arise when applying the ALDT in this example would be whether, and to what extent, the value of customer relations and brand name developed as a result of business activity undertaken overseas should be excised in defining the Australian business as a stand-alone business.

Identification and exclusion of guarantees, security or other forms of credit support

4.55 Division 820 – Thin capitalisation rules of the ITAA 1997 (Division 820) provides that any guarantee, security or other form of credit support provided to the entity in relation to the Australian business from its associates or assets attributable to the entity's permanent establishments is taken not to have been received.²²

4.56 However, the words 'any guarantee, security or other form of credit support' refer only to a formal or legal obligation, not to implicit credit support. Accordingly, there is some uncertainty as to whether the policy of identifying and excising the support provided to the stand-alone Australian business should also extend to implicit credit support that can arise from parent entities or other group entities.

4.57 Arguably, parent or group affiliation is directly relevant to the amount of debt an Australian business can borrow. The strategic position of the entity in the context of the group's business directions, reputation, the economic benefit to the Australian business of using the parent's name and other factors can result in implicit support being provided.

4.58 Not excising implicit parent or group support could undermine the purpose of isolating the stand-alone business. For example, consider a situation where an Australian company is rated on its own as sub-investment grade, but is considered

22 Paragraphs 820-105(2)(e) and 820-215(2)(e) of the ITAA 1997.

core to its parent. This could result in a significant uplift to the Australian company's rating, and as a result, it could be argued by the taxpayer that the company would be able to borrow significantly more debt. The fact the Australian company is making losses would not affect the uplifted 'core' credit rating, as the taxpayer could simply argue that, despite the Australian company's losses, the ultimate parent will continue to fund the Australian company's debt obligations (for example, through equity injections which cover the interest payments).

4.59 Adjustments to credit support to comply with the thin capitalisation rules could be complex and require detailed analysis to be performed.

4.60 For example, if the credit rating of an Australian company was uplifted based on: (1) implicit parent support; and (2) an explicit parent guarantee on a specific debt instrument, several adjustments requiring subjective judgement may be required:

- The credit rating of the Australian business may need to be downgraded to exclude the explicit guarantee. While the ATO may be able to rely on broad guidance contained in independent credit rating agency publications, this often results in a degree of judgement being required.
- The level of 'notching' down for implicit credit support is also a matter of subjective assessment that needs to be taken into account.
- Adjustments may also be required to key items in the cash flow and profit and loss statements (such as interest expense) to reflect the downgraded credit rating of the Australian business.

4.61 Consider the hypothetical case of a listed company headquartered in Australia, for which more than 50 per cent of its revenue is derived from its foreign country operations, and whose debt capital funding is received from independent commercial lenders on the premise that its associate entities would provide explicit cross-guarantees for its debt. A number of scenarios could arise as a result of excising the explicit cross-guarantees:

- the company, as a borrower, would potentially be willing to borrow less debt capital due to its self-perceived weaker ability to meet its debt obligations;
- an independent commercial lender would potentially not lend any debt capital to the company;
- an independent commercial lender would potentially be willing to lend only a lesser amount of debt capital at the same interest rate; or
- an independent commercial lender would potentially be willing to lend the same amount of debt capital but at a higher interest rate to reflect the increased risk in the company and the consequent lowering of its credit rating.

4.62 In the above case, the ATO could have determined that the standalone credit strength/rating of the company was such that an independent commercial lender would lend the same amount of debt capital but at a higher interest rate.

4.63 The analysis would then require further assumptions to be made in relation to the conditions under which the company would carry on its Australian business to reflect the adjustment to the interest rate applicable on the same amount of debt capital. This would result in an increase of the amount of interest expense that the company would otherwise have incurred on the same amount of debt capital.

4.64 The increased expense may have a negative impact for the company's profitability ratios (such as the interest coverage ratio). For example, when applying Steps 4 and 5 of TR 2003/1 with regard to the company's interest coverage ratio, the following steps may be undertaken:

- the company's interest coverage ratio based on the higher interest rate is adjusted to be brought in line with comparable borrowers; and
- the company's interest coverage ratio is adjusted to fall within the default covenants set by its independent commercial lenders.

4.65 In this case, both adjustments under Step 4 and 5 as described in TR 2003/1 may be achieved by lowering the amount of debt capital of the Australian business. Hence, the removal of the associate entity guarantee could result in a lower arm's length debt amount using interest coverage metrics.²³

4.66 The ATO advises that in applying the ALDT, the above reflects a common situation that they are required to consider.

4.67 On the other hand, the excising of formal credit support as part of applying the factual assumptions under the ALDT can, in certain circumstances, lead to inappropriate outcomes. For example, under certain trade finance agreements, the lender may provide the borrower finance on the financial strength of its ultimate shareholders (who would also act as the ultimate buyers of the borrower's products). Often, the ultimate buyers agree to give the lender first right to cash flows from sales or to assign rights in the product to the lender if cash payment is not made on time. Excising such credit support can result in the borrower's arm's length debt amount being less than it otherwise would be. This outcome may not reflect commercial practice, particularly where the lender and borrower are unrelated and dealing independently and similar practices are adopted in the market for that type of finance.

Using a benchmarking analysis

4.68 The ATO has advised the Board that there can be practical difficulties in confirming the arm's length debt amount using a benchmarking analysis (as part of the

23 It is noted that the interest coverage metric alone is not determinative for the arm's length debt amount but is generally considered a significant ratio for consideration.

six step methodology detailed in the TR 2003/1). In particular, the selection of comparable companies could be hampered in the situation where an entity has obtained finance that is not in the form of 'debt' but is treated as debt under Division 974 – Debt and equity interests of the ITAA 1997 (Division 974)).

4.69 The term 'debt capital' in Division 820 is based on the Division 974 concept of debt interest. The term 'debt interest' brings within the scope of debt capital certain holdings that might, on a legal form analysis, not be considered debt but are treated as debt as a result of the debt test in Subdivision 974-B – Debt interests of the ITAA 1997. Consequently, in applying the ALDT, there is uncertainty as to how one should undertake the benchmarking analysis – that is compare the debt capital against entities with debt capital that comprises of a legal form share but in-substance debt under Division 974 or against entities with pure legal form debt funding.

4.70 An example might be a particular legal form share that is a debt interest under Division 974 issued to a related party (for example, the issue of redeemable preference shares to a related entity). If it is concluded that an independent commercial lending institution would not subscribe to a debt interest with terms and conditions equivalent to those of the particular legal form share (for example with deep subordination and certain payment contingencies), it is unclear as to how the benchmarking analysis should proceed.

4.71 On the one hand, it could be said that no such debt capital can be found in the lender market and therefore the interest payable in respect of the debt capital cannot be deducted. Here, the taxpayer could argue that there are comparable instruments in the market, say recent subordinated debt instruments offered to a range of institutional investors in the Australian market, and that they should be accepted as comparable benchmarks for arm's length testing.

4.72 The legislation does not expressly provide an answer whether it would be acceptable to substitute comparable instruments where those additional risks are compensated by a higher return.

Q 4.2 Issues/Questions

The Board seeks stakeholders' comments on issues arising regarding compliance with the requirements of the ALDT, including with respect to:

- (a) whether it is practical to apply separate borrower and lender tests and, if not, how this could be simplified while retaining the integrity of the rules ;
- (b) whether in practice a distinction is made between the amount that an entity 'would' reasonably be expected to borrow and the amount the entity 'could' reasonably be expected to borrow and how this distinction is made. If no such distinction is able to be made, what are the implications for the ALDT analysis;
- (c) whether there is a clear distinction between the 'would' versus the 'could'

element based on international experience in complying with the United Kingdom thin capitalisation rules and, if so, how its design could assist in improving the ALDT;

(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;

(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;

(f) whether there are compliance costs and uncertainties involved in the required identification of the relevant Australian business and, if so, how they could be alleviated without compromising the integrity of the rules;

(g) whether there is a need to better define and provide guidance on the identification and exclusion of certain types of credit support to avoid inappropriate outcomes and, if so, how this could be achieved;

(h) whether there is a need to provide further legislative and administrative guidance to assist the use of benchmarking analysis and, if so, what are the priority areas; and

(i) any other issues faced by stakeholders in applying the required factual assumptions and relevant factors where compliance could be facilitated, and how.

CHAPTER 5: EASING THE ADMINISTRATIVE BURDEN FOR THE ATO

5.1 As noted at Chapter 4, the terms of reference ask the Board to consult on ways to make the ALDT more effective by reducing compliance costs for business and making it easier for the ATO to administer.

5.2 This Chapter is focussed on issues associated with the administrability of the ALDT by the ATO and seeks feedback on potential options for facilitating that administrability. A number of the issues that raise compliance costs for business that were discussed in the previous Chapter also present administrative difficulties for the ATO. In this respect, the issues discussed in this Chapter supplement that discussion.

ISSUES REGARDING THE ADMINISTRABILITY OF THE ALDT

5.3 This section deals with issues that have been identified by the ATO. Stakeholders' views are sought on whether addressing them would assist in reducing uncertainty and easing the administrative burden for the ATO. It is not meant to be an exclusive or comprehensive list of issues for discussion. Consequently, stakeholders are invited to submit their comments on any issues that they consider are relevant to the administration of the ALDT.

Administering compliance with required relevant factors

5.4 Given that the ALDT is not a bright line test, there can be practical difficulties when applying the relevant factors, which can lead to differing views between taxpayers and the ATO, as detailed below.

Uncertainty in determining the arm's length debt amount and the Commissioner's override power

5.5 The application of the relevant factors does not necessarily give rise to a definitive 'amount' of debt, but, rather, to an indicative range or scale of debt that a taxpayer could support. This may lead to uncertainty about where in that range the Commissioner determines the arm's length debt amount to lie. All points in that range could be supportable by the analysis of the relevant factors.

5.6 Given that the determination of the relevant arm's length debt amount is inherently an assessment based on judgment, the power of 'override' granted to the Commissioner of Taxation may create uncertainty for taxpayers. This suggests there may be a need to provide further guidance to taxpayers on the factors that would be considered by the Commissioner of Taxation when exercising the override power.

Applying comparability analysis to substantiate the arm's length debt amount

5.7 When applying the ALDT, taxpayers tend to use a comparability analysis to substantiate the arm's length debt amount. However, the ATO advises that the analysis is often undertaken by taxpayers without a full examination of the relevant factors. Their analysis correlates more to an entity's creditworthiness rather than the creditworthiness of the Australian business. This may suggest that there is a need to provide further guidance to taxpayers on how to properly undertake a comparability analysis.

Assessing the entity's capacity to meet all its liabilities

5.8 The ATO has noted that it is difficult to appropriately administer the relevant factor that requires taking into account an entity's capacity to meet all its liabilities in relation to its Australian business.

5.9 While the ALDT is a year-by-year test, the capacity of an entity to meet its liabilities is essentially tested over a broader time span which will include the life span of the debt arrangement. The ATO advises that it is difficult to critically assess a taxpayer's capacity to meet its liabilities over a long period of time and especially in the context where several tranches of short term cascading finance are used and rolled over at certain future dates.

5.10 The relevant factors require taking into account the entity's capacity to meet all its liabilities (a concept commonly used in the commercial sense to determine solvency) in relation to the Australian business (whether during that year or at any other time). Arguably, the reference to the 'entity's capacity' could be seen as importing all sources available to the entity to meet the obligations of the Australian business, as distinct from solely the Australian business sources. The ATO has noted that it is unclear as to whether this is the intended outcome when regard is had to the factual assumptions that define the 'Australian business'.

5.11 For example, the ATO has noted that in determining the Australian business of an entity, an offshore investment by that entity may have to be disregarded (that is it might be a controlled foreign entity equity excluded from the Australian business under the factual assumptions) yet funds arising from the return on that very investment can, it seems, be reflected in the assets and cash flows of the Australian business (for example a particular shareholding might be excluded, but the cash dividend flowing from the shares would appear to be an asset of the notional Australian business).

5.12 In addition, when applying the ALDT, an entity is required to determine the notional amount of 'debt capital'. When taking into account the entity's capacity to meet all its liabilities, the entity has to have regard to the concept of 'liabilities' instead. The terms 'debt capital' and 'liabilities' may not necessarily be aligned which creates further uncertainty in the application of the ALDT.

Assessing financial ratios and other conditions affecting the Australian business

5.13 The relevant factors require consideration of the profitability, return on capital and debt-to-equity ratios of the Australian business. These ratios will have varying degrees of relevance based on the Australian business' operations, industry, and benchmarking data availability. This can lead to differing views on the emphasis that should be placed those ratios and the weighting to be given to them.

5.14 Similarly, the relevant factors require analysis of comparable markets and the Australian economy. Again, depending on the relevant facts and circumstances (including market information availability), this can potentially result in differences in views between taxpayers and the ATO in terms of the emphasis one should place on those facts and circumstances.

Determination of the notional amount of debt 'throughout the income year'

5.15 Each element of the ALDT requires one to determine the notional amount of debt capital the entity would reasonably be expected to have, and what the lender would reasonably be expected to lend, on arm's length terms and conditions '*throughout the income year*'.

5.16 Paragraph 10.11 of the Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001* provides that the arm's length debt amount throughout the income year is intended to reflect a notional amount of debt capital that would reasonably be expected to have been the entity's average interest-bearing debt amount during the period, having regard to certain factual assumptions and relevant factors.

5.17 Paragraph 119 of TR 2003/1 advocates the use of the same average calculation methods as set out in Subdivision 820-G – Calculating the average values of the ITAA 1997 for the purposes of determining the notional debt amount, unless there are significant and material changes that warrant the amount to be calculated for different periods.

5.18 Notwithstanding the above, the ATO claim that there is some uncertainty as to whether average valuations are available under the ALDT legislative provisions (that is the provisions do not specifically make reference to an average valuation calculation, which would trigger the operation of Subdivision 820-G of the ITAA 1997).

5.19 The ATO has encountered differing approaches to calculating the amount of notional debt capital. The most common approach is to calculate an average notional amount of debt capital by taking the opening and closing balances in the income tax year. The ATO has also seen taxpayers calculate their notional debt capital by using an average of their quarterly balances.

Other factors to be considered 'throughout the income year'

5.20 Similar issues as highlighted above arise when taking into account the relevant factor of debt to equity ratios. An assessment of those ratios needs to be made '*throughout the income year*'.

5.21 A short term change in the economy may impact on the amount of notional debt capital that would be held and provided during a given income year. The ATO claim that it is unclear as to how the notional debt capital amount held throughout the year is to be impacted by this change, how the change is to be taken into account, and whether changes of a short duration (30 days or less) should be ignored.

Limitations of the relevant factors

5.22 The prescribed relevant factors may appear to be inadequate to deal with complex multi-tiered financing arrangements rather than vanilla type of financing arrangements.

5.23 For example, the analysis of cash flows can be hampered in the situation where a multinational group uses hybrid finance and/or stapled instruments to raise funds. Many of these arrangements allow tax preferred distributions to be paid to equity holders. The cash flows cover interest payments but may not be sufficient to cover principal repayments or provide sufficient return on assets (yet such tax preferred distribution arrangements may satisfy investors' risk appetite).

5.24 Notwithstanding that a standard economic and ratio analysis (such as debt coverage ratio, internal rate of return and others) would show relatively poor results, the investment vehicle could manage to obtain funding from third parties given its reliance on more complex multi-tiered financing arrangements. The question arises as to whether the relevant factors for such arrangements can produce an appropriate ALDT analysis.

Qualities of the commercial lender

5.25 Neither the factual assumptions nor the relevant factors have specific regard to the nature of the commercial lender or the market in which it operates. High risk-taking lenders operating in illiquid markets may have different risk appetites and profit expectations than independent commercial lenders operating in liquid markets. This may translate into substantially different amounts that they might be willing to provide.

5.26 While the ATO has not identified cases where high risk taking lenders in illiquid financial markets have been used to justify an arm's length debt amount for thin capitalisation purposes, it has noted that the United Kingdom tax authorities have issued guidance materials on their approach to such a lender market.

Q 5.1 Issues/Questions

The Board seeks stakeholders comments on issues arising regarding the administrability of the requirements of the ALDT, including with respect to:

- (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;

- (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;
- (c) whether there is sufficient legislative clarity and guidance on how the relevant factors should be taken into account and, if not, how it can be improved. This includes:
 - (i) how the comparability analysis to determine the arm's length debt amount should be undertaken;
 - (ii) how to assess the entity's capacity to meet all its liabilities;
 - (iii) how to assess the financial ratios and other conditions affecting the Australian business;
 - (iv) how to determine the notional amount of debt 'throughout the income year'; and
 - (v) how other factors, such as debt-to-equity ratios, should be determined 'throughout the income year'.
- (d) whether there are circumstances where the application of the relevant factors leads or could lead to inappropriate outcomes, and whether there are any suggestions on how to overcome those inappropriate outcomes; and
- (e) whether in determining the arm's length debt amount there is a need to have specific regard to the nature of the commercial lender or the market in which it operates.

OPTIONS TO REDUCE ADMINISTRATIVE COSTS

5.27 A number of options to reduce administrative costs have been suggested by stakeholders to the Board through preliminary consultations. They are listed below in this section but are not meant to cover all potential suggestions. Stakeholders are invited to comment on these suggestions and/or put forward any other suggestions that would assist in reducing administrative costs for the ATO while at the same time not imposing compliance costs for taxpayers and preserving the integrity of the thin capitalisation rules.

Provide flexibility in timing to support ALDT analysis

5.28 The documentation supporting the ALDT needs to be completed by the due date of the lodgement of the income tax return. A similar requirement is applicable under the new transfer pricing rules. Some stakeholders have suggested considering allowing

an extension of time for preparation of the documentation, as that would assist in providing the required substantiation of the analysis and contribute to lower queries and administrative costs.

Harmonise the transfer pricing legislation and the ALDT

5.29 Some stakeholders have suggested that there is scope for having greater reliance on the analysis undertaken under the transfer pricing rules in applying the ALDT. It has been noted that some of the questions that arise in the context of the ALDT analysis are similar to those that arise in a transfer pricing context.

5.30 Conceptually, there are some commonalities in the thin capitalisation and the transfer pricing rules. In particular, the foundation of the thin capitalisation and the transfer pricing rules is built on an arm's length principle. The ALDT and the transfer pricing rules require a similar approach in determining the arm's length debt amount. Taxpayers often revert to the use of a comparability analysis to justify the level of debt for thin capitalisation purposes and the arm's length interest rate for transfer pricing purposes.

5.31 To some degree, there is also an overlap in terms of sources of information relied upon when applying the two sets of rules. It would therefore make sense to adopt a consistent approach in applying the arm's length principle, to the extent that an entity has to rely on the ALDT for thin capitalisation purposes.

5.32 However, there are certain fundamental differences that should be taken into account when considering whether the rules can be aligned or whether the transfer pricing rules can become an effective administrative solution for ALDT.

5.33 Notwithstanding that both the transfer pricing and the thin capitalisation rules are built upon an arm's length principle, there are differences in purpose and therefore in approach to that principle.

5.34 The thin capitalisation rules focus on setting a limit on *the level of debt gearing* an entity can have for income tax purposes (to ensure that multinationals do not allocate a disproportionate amount of debt to their Australian operations). By contrast, in the context of a cross border debt with non-arm's length conditions between two entities (that produce a tax benefit), the transfer pricing rules focus on the arm's length pricing of the *interest rate* in respect of a debt.

5.35 If an Australian business borrowed from a foreign affiliate and the debt was priced conservatively from an Australian transfer pricing perspective, this would result in a relatively low interest expense (and hence relatively low debt deduction claimed). On the other hand, a low interest expense would be favourable for the Australian business when undertaking profitability ratios for the ALDT and support a higher arm's length debt amount. As a result, the relevant tax outcome achieved under the transfer pricing rules can differ from the tax outcome achieved under the thin

capitalisation rules (that is to ensure that multinationals do not allocate a disproportionate amount of debt into Australia).

5.36 While there is some overlap in the economic analysis of the two sets of rules, the tax treatment and/or outcomes which arise as a result of applying the rules can, in some instances, differ. This is because differing factors are required to be taken into account when applying the ALDT and the transfer pricing rules respectively.

5.37 For example, at a practical level, transfer pricing does not require the taxpayer to isolate its 'Australian business' when undertaking its pricing analysis, as the thin capitalisation ALDT requires. The previous transfer pricing rules under Division 13 of the ITAA 1936 would apply to a whole-of-group basis and would include foreign owned entities and permanent establishments as part of the pricing analysis. The new transfer pricing rules under Division 815-B – Arm's length principle for cross-border conditions between entities of the ITAA 1997 looks to conditions between two entities dealing independently with each other. While conditions between two entities may allow a better analysis of the capital structure of the Australian entity, the transfer pricing analysis does not necessarily isolate the Australian business of the entity.

5.38 The transfer pricing rules also factor in credit support, which the thin capitalisation rules exclude. From a transfer pricing perspective, the credit rating of a subsidiary may be affected by credit support from the foreign parent. The impact of such support on the subsidiary could differ depending on the facts and circumstances. A situation may arise such that given the lower credit standing of the subsidiary relative to the parent company, it is reasonable to conclude that the arm's length interest rate should be set at a margin above the interest rate that the subsidiary would be expected to pay for a given debt with the parent credit support. On the other hand, if the operations of the subsidiary are core to the group, the credit rating of a subsidiary could be 'notched' up such that it has the same credit standing as its foreign parent, resulting in the subsidiary paying the same interest rate that the parent would be expected to pay for the debt.

5.39 In deciding whether the transfer pricing rules would be an effective administrative solution for the ALDT, one additional point of differentiation worth noting is the extent to which a taxpayer's debt and capital structure is considered when applying the transfer pricing provisions.

5.40 In considering the arm's length interest rate for a given loan arrangement, all the relevant commercial and financial conditions surrounding the two entities and the arrangement need to be taken into account. Increasingly, there are circumstances where the transfer pricing analysis may involve an examination of the 'as structured legal form' and whether the parties would have entered into the arrangement, and if so, the conditions that would have been agreed.

5.41 However, TR 2010/7 provides that a taxpayer is not required to work out an arm's length amount of debt to demonstrate that the interest rate in respect of the debt is based on arm's length terms.

5.42 The requirement to go beyond the application of the usual transfer pricing approach only occurs in some exceptional cases. As confirmed by the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations July 2010*, it would be appropriate to determine the arm's length interest rate having regard to the debt and capital structure of an entity in a situation where such structure would not make commercial sense, having regard to the assets used and risks assumed in the relevant business operations.

5.43 For further reference, Appendix B contains a table highlighting, at a high level, some of the inherent policy and functional differences between the thin capitalisation and transfer pricing rules.

Q 5.2 Issues/Questions

The Board seeks stakeholder comments on suggested options to reduce administrability costs of the ALDT, including:

- (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;
- (b) whether there is scope for placing greater reliance on the analysis undertaken under the transfer pricing rules in applying the ALDT and, if there is scope, how this can be achieved while preserving the intended outcomes of both regimes; and
- (c) any other options that would assist in reducing administrative costs for the ATO while at the same time not imposing compliance costs for taxpayers and preserving the integrity of the thin capitalisation rules.

CHAPTER 6: ELIGIBILITY FOR THE ARM'S LENGTH DEBT TEST

6.1 As noted at Chapter 3, the policy intent of the thin capitalisation rules is to ensure that multinational entities do not allocate an excessive amount of debt to their Australian operations. In Australia, and similar to thin capitalisation regimes administered in other countries, a safe harbour ratio approach is predominantly applied, as it provides certainty, simplicity and reduces compliance costs for businesses. An ALDT is also available for entities that fail the safe harbour limits but their gearing could otherwise be commercially justifiable.

6.2 This dual approach accordingly seeks to balance the aims of minimising compliance and administrative costs, protecting the revenue base, and recognition of individual commercial circumstances.

6.3 The ALDT, by its nature, imposes greater compliance costs for businesses and administration costs for the ATO. In part, this is a function of having to separate the Australian business from the rest of the entity and identifying the debt that (on an arm's length basis) would be applicable to the former without the support of the latter, a process that may be unnecessary for commercial purposes.

6.4 The previous two Chapters discussed, for entities applying the ALDT, possible ways of reducing compliance costs for businesses and easing the administrative burden for the ATO. This is in a context where, due to the tightening of the safe harbour limits, the ALDT is expected to be used by a greater number of taxpayers and from potentially a wider range of sectors compared to those currently using it, as noted in Chapter 3.

6.5 The terms of reference also ask the Board to consider who should be eligible to access the ALDT and in what circumstances. The issue of eligibility in this regard is particularly important given the compliance and administrative costs of the ALDT. Appropriately focusing eligibility for the test would ensure that unnecessary costs are not borne by taxpayers or the ATO. Conversely, to the extent that these compliance and administrative costs could be reduced, the case for restricting access to the ALDT would tend to diminish.

6.6 The Board has had a round of preliminary consultations to assist it in identifying whether there should be an entry rule to access the ALDT and the particular circumstances that would justify that access.

6.7 This Chapter discusses first the need for the ALDT and then seeks stakeholder feedback on potential entry rules for determining access to the ALDT.

THE NEED FOR THE ALDT

6.8 Some stakeholders have noted that the ALDT is particularly important for infrastructure, property and service sectors, for which cash flow analysis is critical. The safe harbour tests provide simplicity and certainty, but the ALDT is still needed to acknowledge the commercial circumstances of particular taxpayers.

6.9 It has also been noted that access to the ALDT is particularly important for large scale projects undertaken by capital intensive industries (such as LNG projects and electricity generators) that are funded through 'project financing' arrangements (a non-recourse or limited recourse financial structure where debt used to finance the project is paid back from the cash flow generated by the project).²⁴ Project financing is typically a highly leveraged transaction, with levels on average of around 70 per cent of financing in the form of senior debt since the global financial crisis, while the share of equity is around 30 per cent.

6.10 While noting the importance of retaining access to the ALDT, some stakeholders have noted that there may be practical difficulties in applying the ALDT to large scale infrastructure projects. Due to the significant size of the projects and unique financing arrangements, which may involve participation of several unrelated equity sponsors and debt funding provided through syndicated 'project financing' arrangements with parental support provided via a parent guarantee during the construction phase (on a limited recourse basis), ascertaining comparable arm's length debt funding and meeting the requirements of the ALDT could be problematic. Nevertheless, the projects could be significantly important.

6.11 The Board notes that issues related to the use of a benchmarking analysis and the need to disregard credit support in particular circumstances, when they correspond to ordinary commercial dealings and do not represent an integrity concern, were discussed at Chapter 4.

6.12 Large scale projects may involve the following sectors: energy (power stations, gas pipelines and transmission and distribution); infrastructure (toll roads, rail and ports); transport (airports); resources (base metals, precious metals, oil and gas and chemicals); telecommunications (networks and cables); and social infrastructure (hospitals, prisons, sewerage treatment and water).

6.13 It has been noted that in social infrastructure projects, when equity holders face the demand risk, the gearing ratio would generally fall under the safe harbour rules. In contrast, when there is an availability charge (a revenue stream guaranteed or paid by government subject to performance guarantees), gearing can commonly reach 85-90 per cent, requiring access to the ALDT. Some stakeholders have noted that these projects are financed typically with non-related party debt with the cost of capital for equity investors, such as pension funds, being higher than the typical cost of debt. If

24 Project financing is a loan structure that relies primarily on the project's cash flow for repayment, with the project's assets, rights, and interests held as secondary security or collateral.

these projects were not able to access the ALDT and had to reduce their gearing, their cost would increase potentially making them uneconomic.

6.14 Stakeholders have also noted that the property sector relies on stable returns to allow high levels of gearing compared to many other sectors, and so relies on access to the ALDT.

6.15 It has also been noted that for service industries that are outbound-oriented with low levels of tangible assets and high levels of internally generated goodwill (not reflected in their financial statements), the current safe harbour tests are not appropriate and therefore resort is had to the ALDT.

6.16 Stakeholders have noted that while it is feasible to identify sectors that are more likely than others to need access to the ALDT, it is very hard to draw parameters as to precisely define those sectors. It has also been noted that start-ups in all sectors may need access to the ALDT.

DEFINING ELIGIBILITY FOR THE ALDT

6.17 Against the above background, the Board seeks stakeholders' feedback on whether there should be a limitation on the taxpayers that are eligible to access the ALDT and the rationale for it; and if there is going to be a limitation on access to the ALDT, what principles could be adopted in determining such limitation.

6.18 In considering potential eligibility criteria, stakeholders are invited to identify any processes outside the Australian taxation system that may provide eligibility assistance for certain projects, including, for example, designation processes under Infrastructure Australia, processes to identify significant national interest projects, and any other existing or potential external qualification processes that may be available.

6.19 Also, as discussed at Chapter 4, there is a degree of subjective judgement required when applying the ALDT, as both a functional and creditworthiness analysis is required, having regard to certain factual assumptions and relevant factors. This imposes compliance costs for businesses and administration costs for the ATO and could result in conclusions reached by taxpayers and the ATO not aligning.

6.20 As noted before, appropriately focusing eligibility for the ALDT could assist in ensuring that unnecessary costs are not borne by taxpayers or the ATO. One option to avoid unnecessary costs, and that may assist in providing certainty for taxpayers, is if access to the ALDT were restricted by some type of an advance ruling or determination system.

6.21 Stakeholder feedback is sought on whether access to the ALDT should be restricted by an advanced ruling or determination system and, if an advance ruling or determination system were to apply, what would be the appropriate instance to obtain

an advanced ruling or determination from (an established body, a specially designated independent expert panel, or other options).

Q 6.1 Issues/Questions

The Board seeks stakeholder comments on:

- (a) whether there should be a limitation on eligibility to access the ALDT and the rationale for it;
- (b) if a limitation on access to the ALDT is introduced, what principles could be adopted in determining such limitation;
- (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;
- (d) whether access to the ALDT should be restricted by an advanced ruling or determination system; and
- (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.

GLOSSARY

AGAAP	Australian Generally Accepted Accounting Principles
AIFRS	Australian equivalents to International Financial Reporting Standards
ALDT	Arm's length debt test
ATCA	Advance Thin Capitalisation Agreements
ATO	Australian Taxation Office
ATO ID 2012/31	Australian Taxation Office Interpretative Decision 2012/31: Thin capitalisation: exemption — certain special purpose entities (withdrawn)
BEPS	Base Erosion and Profit Shifting
BTWG	Business Tax Working Group
Division 815-B	Division 815-B — Arm's length principles for cross-border conditions between entities of the ITAA 1997
Division 820	Division 820 — Thin capitalisation rules of the ITAA 1997
Division 974	Division 974 — Debt and equity interests of the ITAA 1997
EBITDA	Earnings before interest, tax, depreciation and amortization
EM	Explanatory Memorandum for the introduction of the <i>New Business Tax System (Thin Capitalisation) Bill 2001</i>
HRMC	HM Revenue and Customs
OECD	Organisation for Economic Co-operation and Development
Ralph Report	The Review of Business Taxation chaired by Mr John Ralph AO report entitled 'A Tax System Redesigned' — July 1999
The Board	Board of Taxation
ITAA 1936	Income Tax Assessment Act 1936
ITAA 1997	Income Tax Assessment Act 1997
TR 2003/1	Taxation Ruling TR 2003/1: Income Tax: thin capitalisation — applying the arm's length debt test
TR 2010/7	Taxation Ruling TR Income tax: the interaction of Division 820 of the Income Tax Assessment Act 1997 and the transfer pricing provisions
US	United States of America

APPENDIX A: QUESTIONS

CHAPTER 4:

Q 4.1 Issues/Questions

The Board seeks stakeholder comments on suggested options to reduce compliance costs of the ALDT, including:

- (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;
- (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;
- (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;
- (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;
- (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;
- (f) whether credit support from related parties could be recognised in particular circumstances when they correspond to ordinary commercial dealings and do not represent integrity concerns, and how to determine those circumstances;
- (g) the facilitation of advance thin capitalisation agreements similar to those applying in the UK;
- (h) whether there is a need to provide further legislative or administrative guidance regarding the exemption from the thin capitalisation rules for certain special purpose entities; and
- (i) any other suggestions stakeholders may have drawing on experiences from other countries, for example, Canada, that would assist in reducing compliance costs while at the same time preserving the integrity of the thin capitalisation rules.

Q 4.2 Issues/Questions

The Board seeks stakeholders' comments on issues arising regarding compliance with the requirements of the ALDT, including with respect to:

- (a) whether it is practical to apply separate borrower and lender tests and, if not, how this could be simplified while retaining the integrity of the rules ;
- (b) whether in practice a distinction is made between the amount that an entity 'would' reasonably be expected to borrow and the amount the entity 'could' reasonably be expected to borrow and how this distinction is made. If no such distinction is able to be made, what are the implications for the ALDT analysis;
- (c) whether there is a clear distinction between the 'would' versus the 'could' element based on international experience in complying with the United Kingdom thin capitalisation rules and, if so, how its design could assist in improving the ALDT;
- (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;
- (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;
- (f) whether there are compliance costs and uncertainties involved in the required identification of the relevant Australian business and, if so, how they could be alleviated without compromising the integrity of the rules;
- (g) whether there is a need to better define and provide guidance on the identification and exclusion of certain types of credit support to avoid inappropriate outcomes and, if so, how this could be achieved;
- (h) whether there is a need to provide further legislative and administrative guidance to assist the use of benchmarking analysis and, if so, what are the priority areas; and
- (i) any other issues faced by stakeholders in applying the required factual assumptions and relevant factors where compliance could be facilitated, and how.

CHAPTER 5:

Q 5.1 Issues/Questions

The Board seeks stakeholders comments on issues arising regarding the administrability of the requirements of the ALDT, including with respect to:

- (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;

- (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;
- (c) whether there is sufficient legislative clarity and guidance on how the relevant factors should be taken into account and, if not, how it can be improved. This includes:
 - (i) how the comparability analysis to determine the arm's length debt amount should be undertaken;
 - (ii) how to assess the entity's capacity to meet all its liabilities;
 - (iii) how to assess the financial ratios and other conditions affecting the Australian business;
 - (iv) how to determine the notional amount of debt 'throughout the income year'; and
 - (v) how other factors, such as debt-to-equity ratios, should be determined 'throughout the income year'.
- (d) whether there are circumstances where the application of the relevant factors leads or could lead to inappropriate outcomes, and whether there are any suggestions on how to overcome those inappropriate outcomes; and
- (e) whether in determining the arm's length debt amount there is a need to have specific regard to the nature of the commercial lender or the market in which it operates.

Q 5.2 Issues/Questions

The Board seeks stakeholder comments on suggested options to reduce administrability costs of the ALDT, including:

- (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;
- (b) whether there is scope for placing greater reliance on the analysis undertaken under the transfer pricing rules in applying the ALDT and, if there is scope, how this can be achieved while preserving the intended outcomes of both regimes; and
- (c) any other options that would assist in reducing administrative costs for the ATO while at the same time not imposing compliance costs for taxpayers and preserving the integrity of the thin capitalisation rules.

CHAPTER 6:

Q 6.1 Issues/Questions

The Board seeks stakeholder comments on:

- (a) whether there should be a limitation on eligibility to access the ALDT and the rationale for it;
- (b) if a limitation on access to the ALDT is introduced, what principles could be adopted in determining such limitation;
- (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;
- (d) whether access to the ALDT should be restricted by an advanced ruling or determination system; and
- (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.

APPENDIX B: COMPARISON OF THIN CAPITALISATION AND TRANSFER PRICING REGIMES

Differences	Thin Capitalisation	Transfer Pricing
Scope of transactions	Applies to all debt interests under Division 974 (not only related party foreign debt).	Applies to cross border debt ²⁵ with non-arm's length conditions between two entities (that produce a tax benefit).
Impact of rules on a given debt arrangement	<p>Sets the upper or maximum limit of debt level an entity can have for income tax purposes.</p> <p>If a taxpayer's debt level exceeds a prescribed 'maximum allowable debt amount, their debt deduction will be denied.</p>	<p>Sets the arm's length interest rate applicable to an actual debt amount on a transaction by transaction basis. If the arm's length interest rate is different to the actual rate, the arm's length rate will be substituted for certain purposes.</p>
Tests used for an inward investment entities (non-ADI) ²⁶ and limitation in scope	<p>The maximum allowable debt amount is the greater of the following: (i) a safe harbour debt amount; and (ii) arm's length debt amount.</p> <p>Given that the safe harbour approach is a fixed amount with lower compliance costs, it is more commonly adopted (and therefore provides a debt limit which is not necessarily 'arm's length')²⁷.</p> <p>The ALDT is generally only used by default (that is where an entity fails the safe harbour). This is because it requires subjective analysis, having regard to certain factual assumptions and factors.</p>	<p>Subdivision 815-B of the ITAA 1997 applies the arm's length principle. The provisions are more aligned with the Associated Enterprises article in Australia's double tax agreements.</p> <p>Division 13 of the ITAA 1936 substitutes the actual interest rate for a loan with an arm's length interest rate for the same loan transaction.</p> <p>Subdivision 815-B of the ITAA 1997's general effect of adjusting an entity's profit to reflect the arm's length conditions of the arrangement is restricted in the area of debt deductions to allowing an adjustment to the interest rate only (that is the arm's length</p>

25 The characterisation of debt may or may not align with debt interests under Division 974.

26 The test for outward investing entities (non-ADI) includes a worldwide gearing test.

27 The worldwide gearing debt test for outward investing entities (non-ADI) has incremental costs lower than the ALDT.

Differences	Thin Capitalisation	Transfer Pricing
		rate on actual debt is determined having regard to the conditions under which independent entities would have been expected to operate in comparable circumstances). ²⁸
Methodologies	The ALDT requires two elements to be satisfied: (i) what a borrower would reasonably be expected to borrow as debt capital having regard to certain factual assumptions and relevant factors; and (ii) what an independent commercial lender would reasonably be expected to lend on arm's length terms and conditions having regard to the same factual assumptions and relevant factors.	There are different methods of determining the arm's length interest rate under the OECD Transfer Pricing Guidelines: (i) Direct methods such as comparable uncontrolled pricing (CUP) method, cost plus method and resale price method; and (ii) Indirect methods such as transactional net margin method and profit split method

28 See section 815-140 of the ITAA 1997 – Division 820 of the ITAA 1997 may then require further reduction of the debt deduction if the actual level of debt breaches thin capitalisation.