Australian Government

The Board of Taxation

REVIEW OF THE THIN CAPITALISATION ARM'S LENGTH DEBT TEST

A Report to the Assistant Treasurer

the board of taxation

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Board of Taxation

December 2014

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CONTENTS

FOREWORD **1**

GLOSSARY **3**

EXECUTIVE SUMMARY **5**

CHAPTER 1: INTRODUCTION **7**

Background 7
Terms of reference 7
Review processes 8

CHAPTER 2: EXAMINING THE ALDT IN CONTEXT **11**

Background to the ALDT 11

CHAPTER 3: A TAX INTEGRITY RISK FRAMEWORK FOR VIEWING THE ALDT **17**

The importance of the ALDT 17

CHAPTER 4: ASSESSING ELIGIBILITY FOR THE ALDT **25**

Views in submissions 25
The Board's consideration 27

CHAPTER 5: IMPROVING THE LEGISLATIVE FRAMEWORK FOR THE ALDT **29**

Introduction 29
Credit support from related parties 29
Identifying Australian business operations 34

CHAPTER 6: REDUCING COMPLIANCE COSTS FOR TAXPAYERS AND ADMINISTRATIVE COSTS FOR THE ATO BY DEVELOPING ADMINISTRATIVE GUIDANCE **37**

Introduction 37
The requirement for yearly assessment of the ALDT, and its prospective focus 37
Advanced thin capitalisation agreements 43
Use of benchmarking 44
Additional safe harbours based on earnings 46
Extent of required ALDT assessment when there is no related-party debt 49
Separate borrower and lender tests and the application of relevant factors 53
Time to submit supporting ALDT documentation 56
Ensuring guidance for special-purpose vehicle exemption achieves its objective 58
Future review of ATO guidance material 59

APPENDIX A: SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS **61**

APPENDIX B: LIST OF PUBLIC SUBMISSIONS **65**

FOREWORD

The Board of Taxation is pleased to submit this report to the Assistant Treasurer following its review of the thin capitalisation arm's length debt test.

The Board has made four observations and eight recommendations.

The Board established a Working Group of Board members — chaired by Elizabeth Jameson, and otherwise comprising Teresa Dyson and Keith James — to conduct the review. The Board issued a discussion paper, and held discussions and targeted consultations with a range of stakeholders before and after releasing the discussion paper. It received 12 written submissions, two of which were confidential. The Board would like to thank all those who so readily contributed information and time to assist in conducting the review.

The Board would also like to express its appreciation for the assistance of Nick Houseman, Paul Hooper, Anthea McKinnell and Karen Payne as members of the expert panel; Mark Goldsmith as a consultant engaged by the Working Group; and officials from the Treasury and the Australian Taxation Office.

The *ex officio* members of the Board — the Acting Secretary to the Treasury, Nigel Ray; the Commissioner of Taxation, Mr Chris Jordan AO; and the First Parliamentary Counsel, Mr Peter Quiggin PSM — have reserved their final views on the observations and recommendations in this report for advice to Government.

Teresa Dyson
Chair, Board of Taxation

Elizabeth Jameson
Chair of the Board's Working Group
Member, Board of Taxation

Glossary

ABA	Australian Bankers Association
ALDT	arm's length debt test
APA	advanced pricing agreement
ATCA	advanced thin capitalisation agreement
ATO	Australian Taxation Office
AVCAL	Australian Private Equity & Venture Capital Association Limited
Commissioner	Commissioner of Taxation
CPA Australia	Certified Public Accountants Australia
DTA	double tax agreement
EBITDA	earnings before interest, taxes, depreciation and amortisation
Explanatory Memorandum	Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001
EY	Ernst & Young
ITAA 1936	*Income Tax Assessment Act 1936* (Cth)
ITAA 1997	*Income Tax Assessment Act 1997* (Cth)
OECD	Organisation for Economic Co-operation and Development
PCA	Property Council of Australia
PEs	permanent establishments
PPP	public–private partnership
PS LA	Practice Statement Law Administration
ROE	return on equity
TD	Taxation Determination
TR	Taxation Ruling
TTI	The Tax Institute
UK	United Kingdom
US	United States

EXECUTIVE SUMMARY

The terms of reference for this review asked the Board to review the arm's length debt test (ALDT) contained in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997) as it applies to the thin capitalisation rules. The aim was to reduce ALDT compliance costs for taxpayers, making it easier for the Australian Taxation Office (ATO) to administer and to clarify the circumstances in which the test should apply.

The thin capitalisation regime incorporates several tax integrity measures aimed at addressing the perceived 'debt bias' within the Australian income taxation system. This debt bias arises because of tax deductions for debt financing costs, which are not available for finance raised by way of equity investment. This arguably creates an intrinsic tax-related incentive to choose debt financing which the thin capitalisation rules, amongst other measures, are designed to address.

The thin capitalisation rules address this 'debt bias' by limiting the allowable level of debt deductions for the taxpayer's borrowings based on the level of debt. This limitation can be supported by any one of three tests, namely:

- a strict and formulaic calculation based on the debt-to-equity ratio (the 'safe harbour' test);
- a detailed assessment of the level of debt that — by applying a number of legislative assumptions and factors and using a complex series of verifying tests — can be shown to support the borrowing on an arm's length basis (the ALDT); or
- the formulaic 'worldwide gearing ratio' test which has regard to the taxpayer's gearing levels across its international operations.

It is worth noting that the ALDT is, in a sense, the central plank of the thin capitalisation rules, which aim to allow debt deductions only for commercially justifiable levels of debt. The 'safe harbour' and the 'worldwide gearing ratio' tests are the shortcut for most taxpayers wanting to establish that they are claiming reasonable levels of debt deduction at arm's length.

In the course of the review, the Board confirmed that the vast majority of taxpayers affected by the thin capitalisation regime can operate within the 'safe harbour' limits (see paragraph 2.10), so they need not incur the cost and burden of satisfying the ALDT to justify their debt deductions. However, although not many taxpayers rely on the ALDT, they are generally of the kind that contributes significant economic activity within the services, resources and infrastructure industries. Based on submissions to the review, without the ALDT, many major projects that are highly leveraged particularly in the early stages would be at risk. Naturally, any potential disincentives caused by the Australian tax system are a concern to taxpayers and the Government.

The Board concluded that the ALDT is an important integrity measure within the thin capitalisation rules. Debt deductions that fail either of the other two strictly formulaic tests, and which must therefore resort to the ALDT, ought to be tested rigorously. However, there are numerous identifiable circumstances where the tax-integrity risk is relatively low, and the level of testing to verify the level of debt deduction under the ALDT could be reduced and simplified. This would help reduce compliance costs and relieve the administrative burden for taxpayers and the ATO.

With this in mind, the Board developed a 'tax integrity risk framework' in consultation with the ATO and other stakeholders. The framework aims to help identify circumstances in which the most rigorous testing and verification, in line with present rules, ought to be retained (that is, cases of 'high tax-integrity risk' cases). At the other end of the spectrum, the circumstances for 'low tax integrity risk' could justify lower levels of testing and verification to support arm's length debt deductions, and a spectrum in between those two extremes could justify a commensurate adjustment to the level of testing and verification required.

The Board concluded that much of the complexity and cost in applying the ALDT could be addressed through administrative guidance from the ATO, and by applying the 'tax risk integrity framework' without the need for significant legislative change.

The review also identified a small number of changes warranting legislative amendment. These changes relate to the ALDT requirement, when calculating the allowable level of debt on an arm's length analysis, to exclude, among other things, the availability of credit support. The Board has recommended two legislative amendments to address the commonly observed complexity that arises when attempting to apply this requirement.

The Board also concluded that the ALDT ought not to be available only to particular industries or types of taxpayers. If the recommended administrative guidance and legislative changes are made, it is the Board's view that there should be no need to restrict its application. Indeed, doing so would present a number of definitional problems, in terms of the types of industries or taxpayers to which the test ought to apply. Moreover, on the basis of principle, the Board could see no basis for restricting the reach of the ALDT as long as the principles that underpin it — and its application to taxpayers — are appropriately refined as recommended in this report.

Finally, the Treasurer appointed the Board as the Ministerial Advisory Council (MAC) in relation to tax matters. A significant component of this review has focused on understanding the costs incurred by businesses in applying the ALDT, and whether there are any administrative or legislative changes that could be implemented to ease the compliance burden for taxpayers and for the ATO in applying this test.

Chapter 1: Introduction

Background

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 review the ALDT[1] as it applies to the thin capitalisation rules, to reduce compliance costs for business, to make the test easier for the ATO to administer, and to clarify in what circumstances it 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 ATO to administer.

Terms of reference

1.3 The Board received the following terms of reference:

> 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* (Cth) (ITAA 1997).
>
> The arm's length test is intended to provide a carve-out from the thin capitalisation rules[2] for a level of debt that is considered to be 'commercial or independent'. The arm's length test focuses on what a stand-alone 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 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.
>
> In addition, the Board should consider who should be eligible to access the arm's length test and in what circumstances.

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1 The arm's length test for non-Australian deposit-taking institutions (non-ADIs) is referred to as the ALDT. 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 Board should consider views put forward and provide its recommendations in a report to the Government by December 2014.

1.4 Finally, as part of the Government's deregulation agenda, the Treasurer appointed the Board as the Ministerial Advisory Council (MAC) in relation to tax matters. A significant component of this review has focused on understanding the costs incurred by businesses in applying the ALDT, and whether there are any administrative or legislative changes that could be implemented to ease the compliance burden for taxpayers and for the ATO in applying this test.

REVIEW PROCESSES

Review team

1.5 The Board appointed a Working Group of its members to oversee the review. The members of the Working Group were Elizabeth Jameson (Chair), Teresa Dyson and Keith James. In addition, the Board engaged Mark Goldsmith (a member of its advisory panel) as a consultant to assist with this review. The Board also appointed an expert panel comprising members of its advisory panel — namely Nick Houseman, Karen Payne, Anthea McKinnell and Paul Hooper — to provide further specialist assistance, helping the Board understand the complex operation of the relevant taxation law and its practical application.

1.6 Members of the Board's Secretariat, and Treasury and ATO staff assisted the Working Group.

1.7 The Board's website lists the position and affiliations of the Board's members and advisory panel.

Consultation

1.8 The Board's consultation process has involved:

- preliminary consultations with a range of stakeholders;
- the release of a discussion paper in December 2013, inviting and facilitating submissions; and
- targeted consultation meetings with a number of key stakeholders, following the release of the discussion paper.

Submissions

1.9 The Board received 12 written submissions, including two confidential submissions, in response to the discussion paper.

The Board's report

1.10 The Board has considered the issues the stakeholders raised in their submissions and at the consultation meetings, and the views of the members of the expert panel. However, the Board's recommendations reflect its independent judgment.

Further review

1.11 Having regard to the importance of the thin capitalisation rules, and the expected increase in use of the ALDT as a result of tighter safe harbour rules, the Board recommends a further review of the ALDT within three years.

CHAPTER 2: EXAMINING THE ALDT IN CONTEXT

BACKGROUND TO THE ALDT

The thin capitalisation rules

2.1 The thin capitalisation rules are an integral part of Australia's international tax system and where a number of important taxation and economic policies intersect. These policies include protecting the corporate tax base, ensuring that commercial investment decisions are not impeded, and ensuring that compliance and administration costs are minimised as much as possible.

2.2 An important policy concern in designing and operating the thin capitalisation rules is their impact on foreign investment into Australia. This is a particular concern given that, as a net importer of capital, Australia traditionally relies on foreign investment to boost productivity, increase competitiveness, improve living standards and create employment opportunities.

2.3 The thin capitalisation rules are one set of measures for addressing the existing bias in the tax system in favour of deductible debt funding. Put simply, by providing a deduction for debt and not equity, the tax system arguably encourages debt finance over equity financing.

2.4 The thin capitalisation rules, along with the transfer pricing rules, provide a safeguard against excessive interest being allocated to Australian entities. They limit the level of interest deduction claimed in Australia based on prescribed gearing limits, whereas transfer pricing may limit the deduction claimed in Australia by setting a 'price' in line with an arm's length interest rate.

2.5 The proportion of debt a multinational entity can use to finance its Australian business is limited for tax purposes by the prohibition of deductions considered to represent excessive debt financing from an arm's length perspective. The thin capitalisation rules establish a strict formulaic debt/equity gearing 'safe harbour' beyond which an entity will be subject to the denial of debt deductions unless the entity can satisfy, through rigorous testing, that the amount is reasonable from a commercial perspective. To ensure that there is integrity and fairness, the rules apply to all debt, including related-party debt, third-party debt, and both foreign and on-shore debt.[3]

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3 Table 11.2 at paragraph 11.7 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (Explanatory Memorandum).

2.6 The thin capitalisation rules apply to foreign controlled entities and investors, and to Australian multinational enterprises that have foreign investments in controlled foreign entities or permanent establishments.[4] Associates of Australian multinational entities may also be subject to the rules.[5]

2.7 In broad terms, whether an entity's debt funding is excessive or not is determined by comparing the amount of debt (or equity, in the case of ADIs) used to finance the Australian business 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'.

2.8 An entity can use one of three tests to calculate its thin capitalisation position: the safe harbour test, the ALDT and the worldwide gearing test. That being said, thin capitalisation is ultimately an arm's length test with certain administrative concessions (such as the safe harbour test), designed to ease the compliance burden for taxpayers. Introducing the safe harbour test was intended to provide greater certainty to taxpayers trying to meet the thin capitalisation rules without having to justify their individual capitalisation levels.[6]

2.9 Each of the three tests is available to both outbound and inbound investing entities[7] — that is, 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, including foreign-controlled Australian resident entities; and foreign entities that carry on business at or through an Australian branch, or have direct investments in Australia.

2.10 Historically, the overwhelming majority of entities subject to the thin capitalisation rules have adopted the safe harbour test. The ATO has advised the Board that for the 2013 year, out of a total of 2,757 entities that have lodged thin capitalisation schedules, 2,670 entities applied the safe harbour test.

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4 See section 820-1 of the ITAA 1997.

5 Item 3 of the table in subsection 820-85(2) of the ITAA 1997.

6 Costello, P (Treasurer) 2001, *Thin capitalisation and debt/equity borderline — Changes to Exposure Draft legislation,* media release no. 38, 22 May 2001; see also OECD, *Committee on Fiscal Affairs Report on 'Thin Capitalisation'*, (26 November 1986).

7 The worldwide gearing test was made available to inbound investing entities with effect for income years commencing on or after 1 July 2014.

2.11 The thin capitalisation rules were recently amended to give effect to changes the Government announced in the 2013–14 Budget measures. These amendments[8] were aimed at protecting the corporate tax base from base erosion and loopholes.[9] The following changes were made to the thin capitalisation rules:

- The *de minimis* threshold for application of these rules was increased from $250,000 to $2 million of debt deductions, meaning only interest deductions over $2 million will be subject to scrutiny under the thin capitalisation rules.
- For general entities, the safe harbour limit was 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), meaning fewer taxpayers will be able to take advantage of this safe harbour allowance.
- For non-bank financial entities, the limit was 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), meaning fewer taxpayers will be able to take advantage of this safe harbour allowance.
- For banks, the capital limit was increased from 4 per cent to 6 per cent of their risk-weighted assets of Australian businesses.
- For outbound investors, the worldwide gearing ratio was reduced from 120 per cent to 100 per cent (with an equivalent change to the worldwide ratio for banks).
- The worldwide gearing test was extended to inbound investors.

2.12 As part of the 2013–14 Budget measures, the then Assistant Treasurer and Minister Assisting for Deregulation also announced his request to the Board to undertake this review of the ALDT.[10]

2.13 With the tightening of all safe harbour limits, the Board expects that, going forward, a greater number of taxpayers may use the ALDT, which will have greater significance in determining deduction limits.

The ALDT

2.14 In broad terms, 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 arm’s length debt funding of its Australian business through the relevant period.

2.15 Taxpayers can use the ALDT even if they do not satisfy the safe harbour test.[11] The ALDT requires an examination of the circumstances of the taxpayer to determine

8 *Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014.*

9 Bradbury, D (Assistant Treasurer), *Protecting the corporate tax base from erosion and loopholes — measures and consultation arrangements,* media release no. 38, 22 May 2001.

10 Ibid.

whether the Australian business — when viewed independently from any other business that the entity or its associates had during the period — could have supported the actual amount of debt the taxpayer used on an arm's length basis.

2.16 The ALDT analysis aims 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' an entity would reasonably be expected to have borrowed throughout the income year, which would give rise to debt deductions and would be attributable to the identified Australian business (the 'borrower element').[12]
- 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').[13]

2.17 The ALDT analysis considers factors that an entity would think about when arranging finance for its business, and those factors a prudent commercial lender would consider when deciding whether to provide the finance, and on what terms it would provide that finance.

Factual assumptions

2.18 Subsections 820-105(2) and 820-215(2) outline a number of factual assumptions in determining the arm's length debt amount. The factual assumptions include some conditions that actually exist during the income year, and some conditions that replace what actually happened during that period. Their parameters essentially ask the taxpaying entity to assume a scenario that would exist if the entity carried on only an Australian business; had assets and liabilities comprising only those that are attributable to the Australian business; and had funded its Australian business without financial or credit support from its associates.

2.19 The Australian business is generally identified by reference to the assets that the entity uses or has available for deriving its income other than through foreign subsidiaries or branches.

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11 As noted at paragraph 2.8, 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.
12 Paragraphs 820-105(1)(a) and 820-215(1)(a) of the ITAA 1997.
13 Paragraphs 820-105(1)(b) and 820-215(1)(b) of the ITAA 1997.

Relevant factors

2.20 Subsections 820-105(3) and 820-215(3) outline a number of relevant factors to which regard must be had in determining the arm's length debt amount. Certain factors must be taken into account and must be considered in the context of the above assumptions when analysing whether or not an amount is an arm's length debt amount. The relevant factors are deemed by the legislation to be the factors that a prudent independent party would consider when 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. These factors are outlined in paragraph 2.22 below.

2.21 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 when analysing a particular entity may vary, depending on the facts and circumstances of each case.

2.22 The factors are:

- the functions the entity performed, the assets it used and the risks it assumed in relation to its Australian business throughout the year;[14]
- the terms and conditions of debt capital (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;[15]
- 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;[16]
- the purpose of entering into the loan arrangements in relation to the Australian business throughout the year;[17]
- 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;[18]
- 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;[19]
- the debt-to-equity ratio 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;[20]

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14 Paragraphs 820-105(3)(a) and 820-215(3)(a) of the ITAA 1997.
15 Paragraphs 820-105(3)(b) and 820-215(3)(b) of the ITAA 1997.
16 Paragraphs 820-105(3)(c) and 820-215(3)(c) of the ITAA 1997.
17 Paragraphs 820-105(3)(d) and 820-215(3)(d) of the ITAA 1997.
18 Paragraphs 820-105(3)(e) and 820-215(3)(e) of the ITAA 1997.
19 Paragraphs 820-105(3)(f) and 820-215(3)(f) of the ITAA 1997.
20 Paragraphs 820-105(3)(g) and 820-215(3)(g) of the ITAA 1997.

- 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;[21]
- the way in which the entity financed its commercial activities (other than the Australian business) throughout that year;[22]
- the general state of the Australian economy throughout the year;[23] and
- 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 and that remained on issue throughout the year.[24]

2.23 The legislation makes provision for additional factors to be prescribed by regulation.[25] To date no additional factors have been prescribed.

Commissioner's power

2.24 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.

Record-keeping requirements

2.25 Taxpayers are required to keep records supporting their ALDT analysis, in particular, the factual assumptions and relevant factors that have been taken into account in working out the arm's length debt amount.[26] The records must be prepared before the deadline for lodging taxpayer income tax return for the relevant year.[27]

2.26 Clearly, much of the compliance burden (for taxpayers and the ATO) and cost associated with the application of the ALDT comes from this record-keeping requirement.

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21 Paragraphs 820-105(3)(h) and 820-215(3)(h) of the ITAA 1997.
22 Paragraph 820-105(3)(i) of the ITAA 1997.
23 Paragraphs 820-105(3)(j) and 820-215(3)(i) of the ITAA 1997.
24 Paragraphs 820-105(3)(k) and 820-215(3)(j) of the ITAA 1997.
25 Paragraphs 820-105(3)(l) and 820-215(3)(k) of the ITAA 1997.
26 Subsections 820-980(1) and (2) of the ITAA 1997.
27 Subsection 820-980(3) of the ITAA 1997.

CHAPTER 3: A TAX INTEGRITY RISK FRAMEWORK FOR VIEWING THE ALDT

THE IMPORTANCE OF THE ALDT

3.1 As mentioned in paragraph 2.10, the vast majority of taxpayers take advantage of the 'safe harbour' carve-out from the thin capitalisation rules, and do not incur the time and cost needed to calculate the allowable deduction under the ALDT.

3.2 As highlighted in the discussion paper, where the safe harbour is rarely available because of typically very high gearing ratios, and where the ALDT becomes most commonly relevant, is in the infrastructure, property and service sectors. In these sectors, cash flow analysis is a generally more critical factor supporting borrowings rather than debt/equity gearing levels. While the safe harbour tests provide simplicity and certainty, the wider ALDT acknowledges the vast array of taxpayers' commercial circumstances.

3.3 Accordingly, the ALDT often provides an allowable debt deduction for large-scale projects[28] undertaken by capital-intensive industries such as liquefied natural gas (LNG) projects and electricity generators. These are typically funded through a 'project financing' arrangement (a non-recourse or limited-recourse financial structure where the entity pays back the debt used to finance the project from the cash flow the project generates).[29] These types of projects would generally fail the safe harbour test, which would prevent access to debt deductions and, according to submissions received, put the viability of projects at risk in many cases.

3.4 In these circumstances, and assuming that it is desirable to provide certainty and not to impose tax-driven disincentives for such projects in Australia, the ALDT provides an appropriate method for assessing whether the Australian business of a multinational entity is appropriately capitalised.[30] One of the advantages is that the ALDT generally reflects the economic circumstances of particular industries or businesses that operate with higher gearing ratios than those allowed by the safe harbour rules.

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28 To avoid any doubt, large-scale projects may involve the following sectors: energy (including power stations, gas pipelines, and transmission and distribution); infrastructure (including toll roads, rail and ports); transport (including airports); resources (including base metals, precious metals, oil and gas, and chemicals); telecommunications (both networks and cables); and social infrastructure (such as hospitals, prisons, sewerage treatment and water supply facilities).

29 Project financing is typically a highly leveraged transaction; since the global financial crisis the average senior debt financing has been around 70 per cent and equity around 30 per cent.

30 Paragraph 11.11 of the Explanatory Memorandum.

3.5 The ALDT, by its nature, imposes greater compliance costs for businesses and more administration costs for the ATO than does reliance on either of the 'safe harbour' or 'worldwide gearing ratio' tests. In submissions and during consultation, stakeholders noted the practical difficulties in applying the ALDT to large-scale infrastructure projects.

3.6 A confidential submission noted that due to the significant size and unique financing arrangements of the projects to which the ALDT usually applies, ascertaining comparable arm's length debt funding and meeting the requirements of the ALDT can be problematic. These projects usually involve several unrelated equity sponsors and debt funding provided through syndicated project financing arrangements, with the support of a parent guarantee during the construction phase (on a limited recourse basis). Such projects are generally economically significant and in Australia's national interest.

3.7 The discussion paper indicated that in social infrastructure projects, when equity holders face demand risk, the gearing ratio would generally satisfy the safe harbour rules. In contrast, when there is an availability charge (a revenue stream guaranteed or paid by the Government, subject to performance guarantees), gearing can commonly reach 85–90 per cent, making it necessary to access the ALDT. Some stakeholders have noted that these projects are typically financed by non–related party debt, and the cost of capital for equity investors such as pension funds is generally higher than the typical cost of debt. It was submitted to the Board that if these projects could not access the ALDT and had to reduce their gearing, the increased cost could make them uneconomic.

3.8 Stakeholders also noted that gearing levels differ by industry sector. For example, the property sector relies more on stable returns to allow high levels of gearing compared to many other sectors. It was also 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 test may not provide relief. It was submitted that both of these sectors may need to rely on the ALDT to an even greater extent going forward, as a result of the recent thin capitalisation amendments that reduced gearing ratios for the safe harbour test (see paragraph 2.11).

3.9 The ALDT requires an understanding of the processes third-party lenders use to determine the maximum amount they will lend to a specific taxpayer. Taxpayers and the ATO must have sufficient expertise to step into the role of the third-party lender and establish the specific characteristics of the group affiliate, so they can determine the appropriate amount of debt.[31]

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31 OECD, *Thin Capitalisation Legislation: A Background for Country Tax Administrations* (Pilot version for comments), (August 2012), 9.

3.10 Applying the ALDT requires analysis of an entity's function and creditworthiness. As noted in the discussion paper, these analyses involve some degree of subjectivity, and because the ALDT is not a 'bright line' test there is no guarantee that taxpayer and ATO conclusions will always align.

Risk integrity framework

3.11 The Board considers that rigour is required in establishing the cost and allowability of often substantial debt deductions. However, the Board also considers that there may be circumstances where both the cost to taxpayers of complying with the ALDT, and the administrative burden it imposes on the ATO, could readily be reduced. This is the case where the facts and circumstances reflect a sufficiently low tax-integrity risk of debt loading in Australia. In such cases, it is appropriate to balance the compliance and administrative burden against the objectives of the thin capitalisation rules.

3.12 The Board is of the view that this balance may be achievable by a 'tax integrity risk assessment' approach. This approach requires assessment of the level of risk of excessive debt loading, to determine the extent of testing and the record-keeping requirements. In high-risk scenarios, more extensive testing, in keeping with the current application of the ALDT, would be warranted to establish the arm's length nature of the debt. In low-risk circumstances, such extensive testing is not warranted.

3.13 The tax integrity risk assessment would be heavily influenced by the extent to which the taxpayer's circumstances reflect dealings between independent parties in the open market. On this basis, the more straightforward scenarios involve non–associate party lenders only; there is no direct or indirect involvement by the taxpayer's associates that would influence the amount borrowed by the taxpayer, or the price of that debt.

3.14 Where the Australian taxpayer's associates are involved (because they provided the debt or some form of support) the risk assessment would reflect an expectation that the taxpayer documents, in more detail, reasons as to why their circumstances (in particular, circumstances in relation to the quantum and price of the debt) reflect those that would occur between independent stand-alone parties dealing at arm's length.

3.15 Although it is a simplified summary of the myriad scenarios that exist for taxpayers, Table 1 below provides a guide to how the proposed tax integrity risk assessment framework would operate. In the appropriate circumstances, this guide would suggest that it is appropriate to limit the extent of testing and documentation required to support an ALDT analysis. The Board does not expect this framework to be absolute and there will be cases that sit on the border between low- and high-risk categories, but it does provide a means of assessing when relatively higher and lower levels of testing are warranted.

Table 1

Source of debt	Credit support[32]	The entity operates Australian business only	The entity operates both Australian and non-Australian businesses
Non–associate party debt[33]	Without explicit credit support from related parties	Low risk	Medium risk
	With explicit credit support from related parties	Medium risk	Medium risk
Associate-party debt[34]	With/without credit support from related parties	High risk	High risk

3.16 Under the tax integrity risk framework:

- a high risk rating requires substantially the same level of verification of the amount of debt which can be supported as applies currently;
- a medium risk rating suggests a lower degree of verification is required; and
- a low risk rating suggests that the entity may be afforded substantial relief.

Elements in the tax integrity risk assessment model

Source of debt

3.17 In determining the arm's length debt amount, consideration must be given to the debt capital amount an Australian business would have received from an independent commercial lending institution on arm's length terms. Practically speaking, debt capital is usually raised through independent commercial lending institutions and/or associated entities. Whether the debt is raised through associates or independent non-associated entities will result in different risk assessment outcomes.

Independent commercial lending institution (non–associate party debt)

3.18 In the context of a debt capital structure that is funded solely through an independent commercial lender, it is expected that the documentation prepared to facilitate the loan — and the analysis undertaken by the lender — would potentially satisfy, either directly or indirectly, the requirements of the ALDT.

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32 The reference to 'credit support' in this report refers to any guarantee, security or other form of credit support as set out in paragraphs 820-105(2)(e) and 820-215(2)(e) of the ITAA 1997.

33 The reference to 'non–associate party debt' is a reference to debt from an arm's length third party.

34 The reference to 'associate party debt' in this document includes borrowing from a non–associate party lender where there is a back-to-back arrangement. For example, an associate of the entity may make a deposit of an equivalent and corresponding amount with the non–associate party lender.

3.19 In other words, it is expected that the lender would analyse the nature of the borrower's assets and liabilities, assets available as security, operating industry, current and expected financial performance, and capacity to meet its liabilities (including its creditors) while also providing returns to the shareholder(s).

3.20 It is also expected that an independent commercial lender would regularly monitor and require information to be provided to satisfy itself that the entity will continue to be able to meet its liabilities, and that the assets provided as security (including their value) are still sufficient to meet any obligations owing to the lender. Accordingly, the assessment would generally be accepted based on the lender elements. In such cases, and where the circumstances are supported by other factors that would result in a low tax-integrity risk assessment, there will be less need to focus on the borrower elements.

Associate-party debt

3.21 In the context of associate-party debt, the relationship between the borrower and the lender may mean that the lending practice does not share the same characteristics of independent-party dealings.

3.22 There will be a higher risk assessment rating if the lender is related to the borrower. There will also be an expectation of more detailed risk analysis, including assessing the level of debt the borrower would reasonably be expected to have. In other words, the borrower element of the test would play an integral role in determining the arm's length debt amount.

3.23 Where an entity borrows from a non–associate party lender but there is a back-to-back arrangement — for example, an associate of the entity makes a deposit of an equivalent and corresponding amount with the non–associate party lender — for the purposes of the risk assessment framework the borrowing would be taken to be an associate-party debt.

Credit support

3.24 The exclusion of credit support when calculating the amount of debt that is supportable under the ALDT is based on the proposition that credit support provided by an associate would allow an entity to borrow more than on a stand-alone basis. It requires consideration of a hypothetical scenario where the relationship with the associated enterprise is assumed not to exist. The existence of credit support could potentially increase the tax integrity risk of excessive debt loading in Australia, depending on the purpose of the guarantee and the surrounding facts and circumstances relating to the provision of the credit support, all of which may have an impact on the amount that could be borrowed.

The entity only operates an Australian business

3.25 For the purposes of the ALDT, the term 'Australian business' is defined differently depending on whether the entity is classified as an inward- or outward-investing entity. In the case of an inward investor, the status of the Australian business will also depend on whether the entity is a foreign entity or a foreign-controlled Australian entity. In the case of an outward investor, the Australian business will incorporate the commercial activities connected with Australia excluding any foreign permanent establishment. In addition, the concept requires further adjustments to exclude certain elements that are not taken to be part of the Australian business.

3.26 The classification of risk under the assessment framework has regard to the Australian business and its relevant exclusions. Where adjustments have to be made, a higher risk category may apply if the entity has both Australian and non-Australian businesses. Where the entity's circumstances are such that no adjustments would be required — for example, because the entity only operates its business in Australia and has no associate entity debt or controlled foreign entity debt — and assuming the presence of other low-risk factors, then the entity is in a low risk category.

The entity operates both Australian and non-Australian businesses

3.27 The need for adjustments in determining the entity's Australian business may indicate an increased risk of excessive debt loading in Australia, which may result in a higher (for example, medium) risk rating under the tax integrity risk assessment framework.

3.28 For example, an outward investor that operates a non-Australian business through a foreign permanent establishment would need to exclude its foreign permanent establishment, and an outward investor that operates a non-Australian business through a foreign subsidiary would need to exclude its controlled foreign entity equity.

Scope and application of the risk integrity framework

3.29 The proposed risk integrity framework involves assessing whether various factors are present and whether they support the view that the entity's debt capital structure is supportable on an arm's length assessment.

3.30 At the most basic level, an Australian entity that borrows from an independent commercial lending institution, deploys those and other funds solely in its Australian business (with no advance of debt or equity finance to associate entities or any back-to-back lending arrangements) and does not obtain any financial support for the borrowings from associate entities could be classified as having a low tax-integrity risk of excessive debt loading in Australia. In these circumstances, as explained further in Chapter 6, the documentation, information and extent of arm's length debt testing may be reduced.

3.31 Conversely, a high tax-integrity risk of excessive debt loading in Australia might be present where the entity borrows from an associate entity (whether or not credit support is present). On this approach, it is reasonable to expect a higher level of documentation and information, substantially in keeping with the current application of the ALDT, to justify a debt deduction.

3.32 An example of a medium risk might include a situation as described in the low-risk scenario, with the exception of an associated party providing credit support for the lending. Such a scenario might be regarded as a medium tax-integrity risk of excessive debt loading in Australia having regard to the purpose of the credit support, and the surrounding facts and circumstances relating to its provision, all of which may have an impact on the amount that could be borrowed.

3.33 Where an entity has a debt capital structure that comprises both non–associate party and associate-party debt, the level of documentation and information required to verify the ALDT would generally be greater and would potentially justify a high risk rating. The question that must be answered is whether the Australian business would have been able to borrow the total amount of debt (the associate-party and non–associate party debt) from an independent commercial lending institution. In such cases, the onus is on the entity to demonstrate that an independent lender would have lent that amount in totality, and that an independent entity in the same or similar circumstances to the taxpayer would have been able to support the level of borrowing at the given price of the debt, given all its obligations (to lenders, other creditors, shareholder(s) and so on).

3.34 The following table provides a more detailed explanation of the risk levels shown in Table 1.

Table 2

Risk level	Explanation
Low	Based on the facts and circumstances, there is a low risk of excessive debt loading in Australia. The low-risk category would apply where all of the following factors (and no other factors) are present, that is the entity: • receives debt funding solely from a non–associate party lender; • operates only in Australia and has no foreign operations (for example, no foreign permanent establishments or foreign subsidiaries)[35]; • is not an associate entity of another Australian entity that is an outward investor; • receives no credit support from an associate; and • has no associate-entity debt or controlled foreign entity debt.
Medium	The facts and circumstances would reflect that there is no associate-party debt but there may be some risk of excessive debt loading in Australia — for example, where an entity has to allocate debt between itself and a permanent establishment overseas.[36] This may result in a detriment to the Australian tax base. A more detailed assessment of the facts and circumstances that potentially give rise to this assertion (compared to the low risk category) would need to be undertaken.

35 Commonly referred to as 'controlled foreign entity equity'.

36 Technically speaking, a taxpayer's use of funds is irrelevant when applying the ALDT. However, situations where debt is borrowed in Australia and used solely (or predominantly) offshore would suggest a greater level of review is required.

Table 2 (continued)

Risk level	Explanation
Medium (continued)	The medium-risk category would apply where the entity's debt funding is provided solely by a non–associate party lender and the entity: • has both Australian and non-Australian operations (for example, through a foreign permanent establishment or a foreign subsidiary); • is an associate entity of another Australian entity that is an outward investor; and/or • receives credit support from its associate.
High	The facts and circumstances indicate that in Australia there is associate-party debt and therefore a higher risk of excessive debt loading. This may be detrimental to the Australian tax base. A more detailed assessment of all the facts and circumstances would need to be undertaken.
Note: Material changes in taxpayers' borrowing habits or circumstances may change where a taxpayer falls in the matrix.	

Outcomes of the risk integrity framework — extent of testing and documentation required

3.35 As mentioned earlier, the tax-integrity risk assessment framework leads towards the conclusion that the level of rigour in the testing and documentation required of the taxpayer (in the year of borrowing and in subsequent years) ought to be highest for the high tax-integrity risk scenarios (substantially in keeping with the current application of the ALDT) but could be reduced for medium- and low-risk scenarios. The framework would also support the notion that, particularly in lower-risk scenarios, annual testing should not be required in all circumstances. This is discussed further in Chapter 6.

3.36 The Board worked closely with the ATO in developing the tax integrity risk assessment framework. There is broad agreement that the ATO will issue a discussion paper and endeavour to complete the guidance materials within a reasonable timeframe (likely 6 to 12 months, although this may take longer if the Board's recommendation for legislative change in subsequent chapters is accepted). The Board commends the ATO's willingness to develop administrative guidance on the risk assessment framework and how this would apply in practice.

Observation 1

The Board observes that a 'tax integrity risk framework' approach to applying the ALDT helps identify the scenarios where it may be possible to significantly reduce the compliance cost for taxpayers and the administrative burden for the ATO.

CHAPTER 4: ASSESSING ELIGIBILITY FOR THE ALDT

4.1 The terms of reference asked the Board to consider who should be eligible to access the ALDT and in what circumstances. In particular, the Board was tasked with considering whether there should be a limitation on the taxpayers that are eligible to access the ALDT, and if such a limitation was imposed, the principles on which it would be based.

4.2 The Board noted in the discussion paper that appropriately focusing eligibility for the ALDT could help ensure that taxpayers and the ATO do not bear unnecessary compliance costs. One option identified in the discussion paper was to restrict access to the ALDT by some kind of advance ruling or determination system developed with the ATO.

4.3 The Board consulted various stakeholders to identify whether there should be an entry rule for accessing the ALDT and the particular circumstances that would justify that limitation.

VIEWS IN SUBMISSIONS

Limitation on eligibility to access the ALDT

4.4 Stakeholders, including the ATO, universally supported retaining the ALDT, indicating that the test should be available to all taxpayers. Most stakeholders noted that the ALDT is an important feature of the thin capitalisation rules and were of a strong view that there is no policy justification for limiting access to the test.

4.5 A number of stakeholders highlighted how important it is that the ALDT be available to infrastructure, the property sector, capital-intensive industries, and services entities that have a low asset base or internally generated goodwill. In particular, some stakeholders suggested that the ALDT has a vital role in ensuring that the thin capitalisation rules are applied fairly. This is because the safe harbour debt amount does not take into account assets — such as internally generated goodwill, or the value of reserves or resources discovered.

4.6 Stakeholders raised practical concerns about imposing a limitation as to which taxpayers could access the ALDT. These included concerns about:

- the legislative complexity of defining the criteria, and potential uncertainty in applying the criteria to different factual scenarios;
- the potential inflexibility of the law in catering for changes in which economic or business sectors are considered worthy of accessing the ALDT; and

- an increased compliance burden on taxpayers and the ATO as a result of having to maintain compliance with the potential eligibility criteria.

4.7 It was submitted that a legislative framework to limit and define eligibility would potentially create an additional compliance burden as a result of having to interpret entitlement to access the ALDT. There could be difficulties in interpretation at the edges; for example, how to define what constitutes an infrastructure-related business. Such restrictions risk being arbitrary or inadequately defined, and uncertainty would contradict the policy objective of making the ALDT easier to administer.

4.8 PwC submitted that limiting access to the ALDT could make infrastructure projects less attractive to investors, as debt financing is a key feature of infrastructure investment in Australia and many entities investing in infrastructure are subject to the thin capitalisation rules.

4.9 The Property Council of Australia (PCA) and the Australian Bankers Association (ABA) both submitted that restricting access to the ALDT would have the undesirable outcome of driving up the cost of debt funding in Australia.

4.10 A number of stakeholders also raised the likely difficulty — or impossibility — of defining activity within certain industries or a narrower class of taxpayers for access to the ALDT. The Tax Institute (TTI) similarly stated that restricting access to the ALDT would merely shift the compliance burden and existing uncertainty of the ALDT to the task of determining whether a business falls within the relevant industry and can access the test.

Access restricted by a mandatory advanced ruling or determination system

4.11 In response to the discussion paper, stakeholders' submissions did not support restricting access to the ALDT in any way. While they acknowledged that an advance ruling or determination system would provide certainty to taxpayers, stakeholders submitted that this certainty could already be achieved through the private binding ruling or advanced pricing agreement processes already available at the taxpayer's option.

4.12 The PCA submitted that forcing all taxpayers to apply for an ATO ruling before they entered into any debt funding arrangement could potentially impede investment decisions, block critical projects and unnecessarily increase compliance costs for businesses and the ATO.

4.13 The Australian Private Equity and Venture Capital Association Limited (AVCAL) noted in its submission that the self-assessment regime is a key structural element of the Australian tax system. For that reason, AVCAL did not support the ALDT being restricted by circumstances where an advance ruling or determination is obtained by a taxpayer seeking to apply the test. AVCAL did not support any mandatory or optional advanced thin capitalisation compliance agreements in order to access the ALDT.

4.14 In rejecting the proposition, EY and Chartered Accountants Australia and New Zealand (CAANZ) submitted that the taxpayer costs of compliance and the ATO's administrative burden would likely increase if a mandatory advanced thin capitalisation or determination system were introduced. CAANZ in particular noted that the number of taxpayers potentially seeking to rely on the ALDT as a proportion of the total number of taxpayers affected by thin capitalisation may not warrant any additional disclosures or procedures, considering the need to balance administrative and compliance costs while protecting the revenue base.

THE BOARD'S CONSIDERATION

4.15 As highlighted in Chapter 3, the ALDT is designed to assess the reasonableness of debt deductions from an arm's length perspective, and the safe harbours are the carve-out enabling easier access to deductions in cases where this is clearly appropriate. As such, the ALDT is integral to the Australian thin capitalisation rules.

4.16 The ALDT becomes highly relevant in the infrastructure, property and service sectors, where cash flow analysis is critical and the safe harbour is rarely available. Accordingly, the ALDT often provides allowable debt deductions for projects that can demonstrate an arm's length justification for debt deductions. In light of this, the Board considers that the ALDT is appropriate, as it acknowledges taxpayers' commercial circumstances despite imposing greater compliance costs than the safe harbour or worldwide gearing methods.

4.17 Specifically, on the question of applying the tax integrity risk framework (Chapter 3, Table 1) to ensure more rigorous screening before allowing debt deductions in high tax-integrity risk scenarios, the Board agrees with stakeholders that the ALDT should be retained, and that access to the ALDT should not be limited or restricted in any way. Accordingly, the Board does not recommend introducing an entry rule for access to the ALDT. That is, on the basis that a system is in place to ensure that testing and documentation is adequate in light of the level of tax-integrity risk in a particular case, the Board believes that the ALDT should be retained.

Recommendation 1

Subject to the adoption of all other recommendations in this report, the Board recommends that:

- there should be no limitation on taxpayers that are eligible to access the ALDT; and
- in particular, access should not be restricted by a mandatory advanced ruling or determination system.

CHAPTER 5: IMPROVING THE LEGISLATIVE FRAMEWORK FOR THE ALDT

INTRODUCTION

5.1 The terms of reference asked the Board to consult on ways to make the ALDT 'more effective by reducing compliance costs for business and easier for the ATO to administer'.

5.2 This chapter discusses potential options for reducing compliance costs for businesses and administrative costs for the ATO, through amendments to the legislation. The Board considers that very limited legislative change is required and that most of the compliance burden for taxpayers and the ATO can be addressed through administrative guidance (see Chapter 6).

CREDIT SUPPORT FROM RELATED PARTIES

5.3 As noted in Chapter 2, the ALDT requires that a number of factual assumptions be taken into consideration when determining the arm's length debt amount. One such factual assumption requires the exclusion of credit support. The legislation defines credit supports as:

> '… *any guarantee, security* or *other form of credit support* provided to an entity in relation to the Australian business during that year [italics added] …'

5.4 Essentially, credit support provided to a taxpayer by a related party (an associate) in relation to the taxpayer's Australian business must be disregarded when working out the arm's length debt amount.

5.5 This exclusion is based on the proposition that credit support provided by a related party (an associate) would allow an entity to borrow more than it could on a stand-alone basis (that is, in a hypothetical scenario where the relationship with the associated enterprise is assumed not to exist).

5.6 The Board's discussion paper outlined — as an option for reducing compliance and administrative costs — the possibility of allowing credit support from related parties (that is, not requiring this support to be disregarded) where it corresponds with the entity's ordinary commercial dealings and does not present an integrity concern.

5.7 The discussion paper also highlighted the identification and exclusion of any guarantee, security or other form of credit support as a specific area of uncertainty that leads to substantial compliance and administrative costs. The words 'any guarantee, security or other form of credit support' have been interpreted by the business community to mean a formal obligation but not implicit credit support. The discussion paper questioned whether the policy of identifying and excising credit support provided to a stand-alone Australian business should also extend to the implicit credit support that can arise from the existence of parent entities or other group entities.

Views in submissions

5.8 A number of stakeholders submitted that credit support from related parties should not be disregarded for the purposes of applying the ALDT.

5.9 The PCA stated that it supported allowing credit support from related parties within accepted commercial and integrity boundaries. The PCA stated that property trust groups should be allowed to recognise the financial strength of other related-party Australian entities, similar to the current situation for tax-consolidated corporate groups.

5.10 A confidential submission noted that recognising credit support from related parties is a critical component for project financing, without which many projects would not go ahead. This is particularly relevant where limited-recourse project financing occurs. In this respect, the confidential submission noted that:

> 'Due to the enormous size of most project financings and the huge capital costs associated with resource projects, lenders require this extra parental credit support at least during the construction period of an infrastructure project. Without this support, the lenders will not lend at all and the project simply will not go ahead'.

5.11 Relevantly, the confidential submission also noted that lenders generally require parental credit support, external credit support or some form of construction guarantee to be provided before they agree to finance the project. Parental credit support (normally a guarantee) is usually required for commercial reasons, to give lenders surety that the parent will stand in for the borrower if for some reason the borrower defaults or the project fails. This surety is generally only required during the construction phase when there are no underlying cash flows and costs are at their highest. The parental support falls away once the project commences production.

5.12 The confidential submission went on to explain that the parental support enables projects to achieve better pricing terms, which ultimately results in lower debt deductions, but does not impact the quantum of debt borrowed.

5.13 Given that the ALDT is aimed at determining whether the quantum of debt is reasonable, the confidential stakeholder suggests that the presence or absence of parental support should not be a factor in this determination.

5.14 The confidential submission also noted another impact of not having parent support: lenders, to achieve some extra comfort, will also have their technical consultants work on the project and with management throughout the construction process. This helps to ensure that the lender is aware of risks or issues encountered during construction in real time, and can contribute to their resolution. It can also make projects less efficient, which is another cost for the business.

5.15 Infrastructure Partnerships Australia (IPA) submitted that it is important for the ALDT rules to distinguish credit support provided in infrastructure-project financing from other forms of related-party credit support. It explained that infrastructure project financing typically involves a special-purpose entity raising external debt and on-lending it to one or more 'facilitation vehicles', being entities established solely to deliver, operate and maintain project assets. The external lender generally requires direct security interests over the assets of all the entities in the financing chain.

5.16 A consequence of this type of financing structure is that the borrowers under the on-lending of the external debt might be said to be providing credit support to the special-purpose entity (and other on-lenders) within the financing structure. IPA considers this interpretation an anomalous outcome. IPA recommended that the ALDT rules acknowledge that credit support in this context is intrinsic to the external financing package and is only necessary to provide the external financier with improved recourse to the underlying assets funded by the external debt.

5.17 Some stakeholders also commented on the specific issue of implicit credit support. CAANZ and PwC drew attention to the interaction between the thin capitalisation and transfer pricing regimes, noting that for transfer pricing purposes, implicit credit support is a relevant factor in determining arm's length rates. CAANZ and PwC considered that expressly providing that only *explicit* credit support is to be excluded from the ALDT analysis would provide certainty to taxpayers, would be consistent with commercial lending practices, and would better harmonise the thin capitalisation and transfer pricing regimes. CAANZ also submitted that clarifying the exclusion would lower the administrative burden for the ATO.

ATO perspective

5.18 In the course of the review, the ATO advised the Board that it considers that the existence of implicit credit support could improve the borrower's risk profile, which can in turn result in a higher credit rating (as determined using rating agencies' credit rating methodologies). On this view, a higher credit rating may enable an entity to obtain lower-cost funds and, indirectly, a higher level of debt relative to what it could have borrowed without such support.

5.19 If taxpayers are not required to excise implicit credit support from the ALDT analysis, the ATO is concerned that this may drive undesirable behavioural outcomes, particularly in relation to a borrowing from an associate entity. For instance, where the amount determined by the entity to be the arm's length debt amount appears to be excessive relative to what it would have borrowed without the implicit support, the existence of implicit support may be relied upon to justify the actual amount borrowed.

5.20 Finally, the ATO is also of the view that any position taken in respect of the existence or non-existence of implicit credit support in a transfer pricing or ALDT analysis should be consistent.

The Board's consideration

5.21 The Board considers that there is a distinction between explicit and implicit credit support. The ATO's 2008 discussion paper entitled 'Intra-group finance guarantees and loans', although now withdrawn[37], provides a useful explanation of the distinction:

- 'explicit credit support', a formal legal agreement — whether a guarantee, a letter of comfort or another assurance — by which an enterprise (the guarantor) agrees in respect of a loan to an associated enterprise to pay to the lender any amount payable on that loan in respect of which the borrower defaults; and
- 'implicit credit support', which includes (i) a letter of comfort or similar statement of intent that does not constitute a contractually binding commitment of the type referred to above, and (ii) credit support obtained as an incidental benefit from the taxpayer's passive affiliation with the multinational group, its parent or another group member.

Explicit credit support

5.22 The Board recognises that, in normal commercial situations, credit support and guarantees are often standard requirements of independent lenders and are considered essential to large-scale property, resources and infrastructure construction projects. It is also acknowledged that it is important for the tax system not to impede important infrastructure and other projects if Australia is to remain, or become more, internationally competitive.

5.23 In these commercial situations, credit support is necessary to provide lenders with surety that the parents, or another entity, will step in for the borrower in the event that the project fails or the borrower otherwise defaults on its obligations. The Board understands that this surety is generally only required during the construction phase of the project and, once the project commences, the support is no longer required.

5.24 Without the explicit credit support in such cases, lenders may refuse to lend any amount and the project may not proceed. In these situations, the existence of the credit support generally does not affect the *amount* that can be borrowed, but it does determine whether *any* amount will be lent at all and, if so, the pricing terms the borrower can achieve. With regards to the latter, the existence of credit support can reduce the credit risk associated with a project and lower the interest rate at which the borrower can borrow.

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37 ATO, Minutes of the Transfer Pricing Sub-group of the National Tax Liaison Group, October 2010.

5.25 The Board agrees in principle that, having regard to commercial understandings and the industry norm, credit support of this kind should not automatically be disregarded from the ALDT analysis where the support corresponds with ordinary commercial dealings. When the industry norm is to require support to essentially 'rubber stamp' the financing (that is, the support does not impact the amount that a taxpayer could borrow in a commercial transaction), such support should not be required to be disregarded from the ALDT analysis. Put another way, the mere existence of credit support should not be fatal to the determination of an arm's length stand-alone debt amount in such cases.

5.26 Legislative clarity is required to ensure that the mere existence of explicit credit support does not preclude access to the ALDT where such support is required, as a matter of course, by an independent commercial lender, and the entity can sustain the level of debt on a stand-alone basis. This is equally important where the existence of explicit credit support does not facilitate an increase in the quantum of debt, but merely lowers the price of the debt. In these circumstances, the cost of debt is reduced and a lower debt deduction is available.

Implicit credit support

5.27 The Board also considers that the words 'any guarantee, security or other form of credit support' should be amended to make clear that implicit credit support is not required to be excluded from the ALDT analysis. It is extremely difficult — sometimes almost impossible — to define and identify all types of implicit credit support. Moreover, it appears to the Board that implicit credit support tends to affect the price of debt but not the amount of debt available in commercial dealings.[38] As the ALDT is aimed at establishing whether the quantum of debt is reasonable, the presence or absence of implicit parental support ought not to factor into the analysis.

5.28 As highlighted in paragraph 5.21, implicit credit support does not constitute a contractually binding commitment. It refers to incidental, passive benefits that a group member derives from a group affiliation such as an enhanced credit rating for being part of a larger group. This type of support merely requires an expectation that in the event of a default, the parent or other group member may 'bail out' a subsidiary company, without any legal obligation to do so.

5.29 The Board also understands that implicit credit support is generally not a relevant factor taken into consideration by independent commercial lending institutions in assessing the amount to lend, which is the crucial question in an ALDT context. Rather, implicit credit support is considered from a 'relationship' perspective and often only affects the pricing terms of the debt.

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38 The Board independently consulted with a major Australian commercial lending institution as well as the Australian Prudential Regulation Authority (APRA). Through discussions with these bodies, the Board understands that implicit credit support is an important factor that goes to the relationship that a taxpayer has with the lending institution and, in turn, the pricing terms that the lending institution is willing to provide.

5.30 The Board also understands that taxpayers frequently do not excise implicit credit support in applying the ALDT because of the practical difficulty of doing so. Moreover, the ATO's compliance work to date has not focused significantly on this aspect, given the small number of taxpayers that have relied on the ALDT.

5.31 In light of this, the Board recommends that the ALDT be legislatively amended to make clear that implicit credit support does not need to be excised when applying the ALDT. One way of achieving this is to have the legislation refer only to explicit credit support.

5.32 With regard to the PCA's suggestion that property groups should be allowed to recognise the financial strength of other related Australian entities (similar to the tax consolidation regime), the Board considers that this is a broader thin capitalisation issue and a matter of fundamental Government policy, not necessarily within the terms of reference of the ALDT review.

Recommendation 2

The Board recommends that:

- the ALDT legislative assumptions be amended so that explicit credit support is not required to be excluded for the purposes of calculating the allowable level of debt deduction, where the nature of the loan and of the explicit credit support is such that although the type of explicit credit support provided would generally be required by an independent commercial lender, it would not affect the amount of debt the borrower could access, and the entity can sustain the level of debt on a stand-alone basis; and
- the ALDT legislative assumptions be amended so that implicit credit support does not have to be excluded for the purposes of calculating the allowable level of debt deduction.

IDENTIFYING AUSTRALIAN BUSINESS OPERATIONS

5.33 The factual assumptions that must be made as part of an ALDT analysis require the identification of the relevant Australian business assets, liabilities, profits, cash flows and risks assumed.

5.34 As noted in the Board's discussion paper, it can be difficult to attribute amounts to the commercial activities, assets and liabilities of the 'Australian business' where the entity's actual business includes significant offshore activities — or significant onshore or offshore debt or equity holdings in associates or affiliates.

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

5.36 The Board noted in the discussion paper that there are a number of practical limitations in reconstructing the 'Australian business' financials.

Views in submissions

5.37 A confidential submission expressed concern with the need to isolate the Australian business or Australian assets in their particular industry. The submission noted that when isolating the Australian business or Australian assets, activities and assets relating to overseas permanent establishments are specifically excluded from the definition of those terms. This has a particular impact on those operating in certain limited types of industries in which the taxation of profits associated with those types of businesses are required under most double tax agreements (DTAs).[39]

5.38 To illustrate the issue, assets attributable to permanent establishments in most industries are excluded from the ALDT calculation, but are generally exempt from paying income tax on the profits in Australia.[40] This outcome is not reciprocated in the relevant industry in relation to which the confidential submission was received, as an exemption is generally not available in that industry by virtue of relevant DTAs.

5.39 The confidential submission went on to say that inequitable outcomes also arise when a business is carried on through a permanent establishment that results in these activities being excluded from the Australian business for the purposes of the ALDT. Similar to the situation with business assets, it was asserted in the submission that it would be more appropriate when identifying the relevant 'Australian business' to re-include any business carried on through an overseas permanent establishment in the definition of 'average Australian assets'.

5.40 Deloitte noted in its submission that the requirement to identify and isolate the Australian business or Australian assets can be practically complex. However, they acknowledged that it is 'likely a necessary aspect' of the ALDT. In this context, Deloitte also noted that further clarity is required in relation to whether income streams (including dividends) received from, and related expenses paid to, overseas subsidiaries can be taken into account for the test. Deloitte submitted that administrative guidance should also confirm whether assets such as cash assets arising from accumulated dividends received are taken into account in defining the Australian business.

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39 Most DTAs deem the use or operation of substantial equipment as creating a permanent establishment and, for instance, the 'Air and Shipping Profits' article in most DTAs will generally allocate taxing rights in respect of international transport activities to the state in which the entity is resident.

40 Under section 23AH of the ITAA 1936.

The Board's consideration

5.41 The Board considers that identifying and isolating the Australian business and Australian assets can be problematic in certain industries. This is particularly so where DTAs are in operation.

5.42 As noted above, this issue has a significant impact on a very limited number of taxpayers in certain industries. The question of whether a business carried on through an overseas permanent establishment should be re-included in the definition of 'average Australian assets' is a fundamental question of Government policy and so is not a matter on which the Board is in a position to make a recommendation.

5.43 In addition, the Board also recognises the uncertainty created in this analysis regarding the treatment of income streams received from, and related expenses paid to, overseas subsidiaries and cash assets arising from accumulated dividends. Accordingly, the Board considers that administrative guidance should be developed in this area to ease the compliance cost to business and administrative burden for the ATO.

Observation 2

The Board observes that identifying and isolating the Australian business and Australian assets can be problematic for a very limited number of taxpayers in certain industries. The question of whether business carried on through an overseas permanent establishment should be re-included in the definition of 'average Australian assets' is a fundamental question of Government policy and so is not a matter on which the Board is in a position to make a recommendation.

CHAPTER 6: REDUCING COMPLIANCE COSTS FOR TAXPAYERS AND ADMINISTRATIVE COSTS FOR THE ATO BY DEVELOPING ADMINISTRATIVE GUIDANCE

INTRODUCTION

6.1 The terms of reference for this review asked 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 the test.

6.2 This chapter discusses potential options to reduce compliance costs for business and administrative costs for the ATO through the development of additional administrative guidance by the ATO. Rather than looking at legislative amendments, the Board has focused on identifying possible administrative solutions and treatments to address issues with the ALDT, and has worked closely with the ATO to do this.

THE REQUIREMENT FOR YEARLY ASSESSMENT OF THE ALDT, AND ITS PROSPECTIVE FOCUS

6.3 In the discussion paper, stakeholders raised concerns about the retrospective focus of the ALDT and the fiction that it creates compared to the position of an arm's length commercial lending arrangement, which is forward-looking. Stakeholders raised for consideration whether the factual assumptions and relevant factors could be made to be prospectively focused, to better reflect the relevant economic conditions affecting Australian businesses.

6.4 The discussion paper suggested that one way to remedy the retrospective focus would be to remove the annual reapplication of the ALDT. The alternative is an initial requirement to apply the test at the time of borrowing, subject to a required reassessment if and when there is a material change in the borrower's circumstances.

Views in submissions

6.5 All submissions supported removing the annual reassessment and the ALDT having a prospective rather than retrospective focus.

6.6 The PCA submitted that the annual requirement to undertake the ALDT assessment was an unnecessary compliance burden on the ATO and the taxpayer, adding that it is out of step with commercial practice.

6.7 EY stated that the requirement to annually reassess compliance with the ALDT having regard to factual assumptions and relevant factors prevailing during each income year may create outcomes which are disconnected from the real arm's length facts and circumstances that are taken into account in setting a particular debt level.

6.8 Some stakeholders did consider that annual re-evaluation having regard to prevailing facts and circumstances may be required in certain situations. For example, annual re-testing may be required if a loan is not from an arm's length lender, or for at-call loans where the lender has the ability to call for repayment at any time.

6.9 A number of stakeholders stated that testing should only be required if there is a material or substantive change in the borrowing terms. Regarding what should constitute a material change, some stakeholders noted that:

- materiality should reflect events that would trigger a review by lenders in a commercial setting, and different review triggers should apply for borrowings from associated and non-associated lenders (in the PCA submission);
- a material change could include a change to the key terms of the loan agreement such as a substantial change to the debt amount or the duration of the rate of interest charged (in a confidential submission);
- organic growth or contraction of a business should not be considered a material change and when assessing whether a material change has occurred, regard should be given to whether any investment acquisitions or disposals have occurred that have impacted the total level of debt funding by greater than 10 per cent (in the ABA submission);
- a material adverse change might be defined as a change in the financial performance of the borrower that would result in a breach of financial covenants or material adverse change clauses that would be expected to be incorporated in an arm's length loan agreement having regard to the borrower's credit profile and other circumstances (in the PwC submission);
- the criteria used to determine what constitutes 'material change' could include where there has been a significant change in the nature of the taxpayer's business; new debt has been raised in the relevant income year; and/or there is a deterioration in the financial performance of the borrower such that it would result in a breach of financial covenants that would be expected to be incorporated in an arm's length agreement having regard to the borrower's credit profile (in the CAANZ submission); and
- it is not possible to prescribe what would constitute a material change, as this will depend on the taxpayer's circumstances (in the Deloitte submission).

6.10 CAANZ and PwC both acknowledged that the flexibility to apply the ALDT only at the time the debt capital was raised is already available to taxpayers under the thin capitalisation rules,[41] although legislative clarity would be welcomed. In this respect, CAANZ stated that:

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

6.11 Deloitte noted that, in the absence of a ruling, it was difficult to see how removing the requirement for an annual test could be applied on a self-assessment basis, although clearly the taxpayer can, within the scope of the current ALDT regime, elect to limit the repetition of work and simply focus on material changes.

The Board's consideration

6.12 The Board considers that the common interpretation of the ALDT as requiring annual testing imposes a significant compliance burden on taxpayers and the ATO. Limiting annual testing to situations where a material change has occurred would significantly reduce this compliance burden. That is, the extent of testing in years subsequent to the first lending year should depend upon whether a material change in the status of the taxpayer or the loan itself occurs at a subsequent time. Any subsequent material change in the lending will require a review of the applicable risk category under the proposed tax integrity risk framework (see Chapter 3, Tables 1 and 2) to determine where the loan sits in subsequent years and whether further testing is required.

6.13 Table 3 below further explains the suggested extent of documentation required, based on the risk assessment framework.

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41 See paragraphs 10.55 to 10.56 in the Explanatory Memorandum and Taxation Ruling TR 2003/1.

Table 3

Level of risk	Extent of ALDT analysis and documentation required
Low	***Consequence:*** In the year of borrowing, the entity must carry out a limited inquiry into the application of the ALDT.[42] ***Expectations:*** Where the six-step methodology as currently set out in Taxation Ruling (TR) 2003/1 is used, steps 1 to 6 may require no analysis or a very limited analysis, and existing documentation used for other commercial purposes may be used for the purposes of ALDT. The entity would be required to maintain evidence to reflect that it falls within the low-risk category.
Medium	***Consequence:*** In the year of borrowing, the entity may be able to carry out a less-detailed analysis into the application of the ALDT. ***Expectations:*** Where the six-step methodology as currently set out in TR 2003-1 is used, a less-detailed analysis is required in relation to certain steps. Importantly, it would be necessary to understand how the borrowing is affected by: • the provision of credit support by associate entities; • use of funds in the Australian business and/or non-Australian business; and[43] • any other available non-Australian business income, cash flow, profits or assets. These factors would then drive the extent of analysis and adjustments required in relation to steps 1 to 5. If these factors do not have an impact on the amount borrowed, a limited analysis may be sufficient. The entity would be required to maintain evidence to reflect the rationale behind the extent of the analysis adopted.
High	***Consequence:*** In the year of borrowing, it is necessary for the entity to carry out a detailed analysis of the application of the ALDT. ***Expectation:*** Where the six-step methodology as currently set out in TR 2003/1 is used, a full analysis of the ALDT is required to address the independent borrower and lender tests, having regard to the factual assumptions and relevant factors that affect the entity.

6.14 The Board noted that the ATO agrees that this approach is permissible without changing the legislation. As such, the Board supports an approach where this position is clarified through updated administrative guidance. By doing this, the Board considers that the compliance costs associated with these rules could be significantly reduced.

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42 If there is a material change in a subsequent year, the entity will need to assess which risk category it falls within and undertake the ALDT analysis accordingly. This applies to all entities in all risk categories.

43 To clarify, some level of analysis and documentation would still be required in circumstances where amounts borrowed are not used solely in Australia and/or the entity has offshore operations.

6.15 Using this framework, the Board also envisages that the verification and testing should require testing to be repeated only in years when a 'material change' occurs. A material change means a change in the terms or nature of the loan, or in the status of the taxpayer, that causes the borrowing to be reclassified under the tax risk integrity framework.

6.16 This means taxpayers would only need to assess that no material changes had occurred during the income year that would change the result of their analysis under the framework. In this respect, it would be prudent to clarify what events may constitute a 'material change'.

6.17 The Board considers that the types of events that constitute a material change for a particular taxpayer will often vary depending on the taxpayer's particular facts and circumstances. Accordingly, the Board acknowledges that it may be difficult for the ATO to fully prescribe all the events and circumstances that could give rise to a material change. An all-encompassing definition of material change may be difficult to achieve (given varying commercial activities and changing business environments), but the Board considers that the ATO guidance could include a series of focusing questions for taxpayers, based on changes in:

- the entity or its Australian business;
- the features related to the debt; and
- the relevant business environment.

6.18 This would help taxpayers consider how, for example, a change in the business or a change in the environment might affect cash flows, financial ratios and ultimately the amount borrowed (from both the lender and borrower's perspective).

6.19 Some focusing questions that may help determine whether there has been a material change in relation to the entity's business could include, for example, whether there has been a change:

- to the entity's Australian business (for example, an acquisition, divestment or the obsolescence of a material asset or assets), a change in the functions or nature of the business performed by the entity, or a change in the risks assumed by the entity; or
- in the performance of the entity's Australian business that has or could potentially have an adverse impact on the ability of the business to meet its obligations (including its ability to pay its creditors and provide a commercial return to shareholders);[44] and

44 This could include a decline in financial performance, as measured by cash flows, profits or rate of return on capital. In other cases, a provision for meeting significant future liabilities is created.

- the structure of the entity's group, including a change in control of the entity, a merger or consolidation, any internal business reorganisation (including a transfer of assets or functions between the entity and its permanent establishment).

6.20 Some focusing questions that may help determine whether a material change has occurred in relation to the entity's debt could include, for example, whether there has been a:

- breach or change to any financial covenants set out in any of the loan agreements;
- significant fall in the value of the assets provided as security for the loan;
- significant change in the interest rate charged;
- change in the duration or term of the loan, or a change to the repayment obligations; or
- refinancing of the loan.

6.21 Some focusing questions that may help determine whether a material change in relation to the relevant business environment could include, for example, a change:

- in market conditions that has or may have an adverse impact on the entity's business. This could include, for example, a change in regulatory or statutory conditions in the industry in which the entity operates; the expiry or expected expiry of patents; the possible introduction of major new competitors; or the loss of any subsidies; and
- in the Australian economy that has had an adverse impact on the entity's business. This could include a change that has affected sales revenue, a significant increase in costs or an unanticipated change in exchange rates.

Recommendation 3

The Board recommends that the ATO develop updated administrative guidance, consistent with the tax risk integrity framework, to enable reduced testing and verification of the ALDT requirements. In this respect, the guidance should require that taxpayers only need to assess that no material change occurred during the income year that would change the result of their analysis under the framework.

Given the focus on 'material change', the Board also recommends that the updated administrative guidance include a series of focusing questions based on changes to (i) the entity or its Australian business, (ii) the features related to debt and (iii) the relevant business environment, to help taxpayers determine when a 'material change' has occurred.

ADVANCED THIN CAPITALISATION AGREEMENTS

6.22 The discussion paper noted the suggestion that advanced thin capitalisation agreements (ATCAs) with the ATO — similar to those that apply in the United Kingdom — could help reduce uncertainties and compliance costs for taxpayers.

6.23 Notwithstanding the benefits associated with this option, the discussion paper also noted that this option could imply an additional administrative burden for the ATO as the ATO would need to have in place the required staff and skills to implement these agreements in a timely fashion.

6.24 This option is distinct from the advanced ruling or determination system discussed in Chapter 4 as an option for limiting the application of the ALDT. An ACTA would be obtained through discussions with the ATO aimed at determining a method and set of parameters for calculating the arm's length debt amount for each year of the agreement (similar to the existing advanced pricing agreement (APA) process already in existence for transfer pricing).

Views in submissions

6.25 A number of stakeholders did not support the introduction of mandatory or optional ATCAs, arguing that these agreements would only increase compliance costs and add to the ATO's administrative burden.

6.26 The PCA considered that there would be limited benefit in introducing ATCAs. Its submission noted that it could be difficult to set appropriate commercial parameters for agreements that will provide taxpayers with the desired certainty within appropriate timeframes. The PCA also suggested that introducing ATCAs could impose an even greater administrative burden on the ATO.

6.27 A confidential submission submitted that availability of ATCAs could be desirable if they were not compulsory. The submission cautioned that ATCAs would increase compliance costs, as there would be a need first to undertake the arm's length debt amount calculation and then ensure the ATO fully understood the arrangement. It submitted that the ATO would need to demonstrate considerable commercial understanding of project financing arrangements, including the specifics of the relevant projects. The ATO would also need to be able to sign off on ATCAs in relatively short periods of time.

6.28 Another confidential submission welcomed ATCAs to support the administration of the thin capitalisation regime, particularly in terms of related-party debt. It argued that ATCAs would provide certainty to taxpayers and improve the ATO's visibility of related-party transactions.

6.29 CPA Australia and TTI also supported ATCAs. CPA Australia noted that introducing ATCAs would be consistent with the APAs administered by the ATO, and TTI stated that it did not expect a large number of requests for ATCAs.

6.30 PwC argued that an advanced ruling or determination system would provide certainty for taxpayers, but that this could be achieved through the existing private ruling or APA system at the taxpayer's option.

6.31 Deloitte also supported an advance ruling determination program, as it would provide certainty to taxpayers and an opportunity for the ATO to improve its capability in this area. It suggested publishing sample agreements, as occurs in the UK.

6.32 The Board's consideration

6.33 The Board agrees with the view that there are already mechanisms in place enabling taxpayers to obtain certainty with respect to their thin capitalisation positions. The existing mechanism of private binding rulings fulfils this purpose. The Board recommends that these rulings continue to be available, and there is no need to introduce ATCAs.

6.34 In saying this, the Board acknowledges that having an ATCA process ensures the ATO has adequate expertise to deal with technical issues (such as creditworthiness) that often require an exercise of judgment as to an appropriate commercial outcome.

Recommendation 4

The Board recommends no changes to the existing process, and that taxpayers who wish to obtain certainty with respect to their thin capitalisation positions should continue to have the option of obtaining a private binding ruling, with no need to introduce ATCAs.

Observation 3

The Board considers that ATO officers should be provided with sufficient training and expertise to deal with technical issues that require the exercise of judgment regarding the ALDT. In this respect, the Board observes that ATO officers could receive additional training to ensure they have the appropriate capabilities.

USE OF BENCHMARKING

6.35 The discussion paper raised a concern that it is quite difficult, in practice, to confirm an arm's length debt amount using a benchmarking analysis. The ATO issued TR 2003/1, outlining the six-step methodology that must be followed when applying the ALDT. This methodology includes undertaking a benchmarking analysis.

6.36 In particular, the discussion paper noted that selecting comparable companies could be hampered in the situation where an entity has obtained finance that is not in the form of 'debt' but is still treated as debt under Division 974 of the ITAA 1997.

6.37 Against this background, the discussion paper sought stakeholder feedback on whether taxpayers should have additional legislative and administrative guidance to help them conduct the benchmarking analysis and, if so, what were the priority areas.

Views in submissions

6.38 Stakeholders gave limited feedback on whether they needed additional legislative and administrative guidance to assist with the benchmarking analysis.

6.39 A confidential submission acknowledged that benchmarking is a large issue in conducting the ALDT — especially from a project financing perspective, where in particular cases given the size, scale and complexity of the transactions, there is nothing comparable against which to benchmark. With regard to guidance required, the submission stated that:

> '… areas of guidance would be necessary with regards to credit support, particularly if no changes are made to carve project financing out of the requirements to disregard credit support during construction. In particular, whether seeking external third parties to provide credit support to the lenders for a fee would support an appropriate benchmark'.

6.40 It further argued for formal clarity to ensure that, when changing the classification of a legal form instrument as a result of the Australian debt and equity rules in Division 974 of the ITAA 1997, alternatives are allowed for comparison.

6.41 Deloitte suggested that improved administrative guidance is required explaining in detail how to apply the ALDT, and case study examples that distinguish between different industries. It suggested that this guidance could show the typical factors lenders consider, such as interest coverage, debt-to-EBITDA, and loan-to-value ratios for property.

The Board's consideration

6.42 The Board acknowledges that benchmarking analysis in applying the ALDT is an area that would benefit from additional administrative guidance. In particular, the Board considers that the process involved in selecting industry comparisons and information sources that the ATO commonly adopts in its analysis of the ALDT would be particularly relevant to stakeholders. This would include ratios that may typically be relevant for certain industries, using case study examples to illustrate how to apply the ALDT across those industries, without detracting from the required flexibility in applying the ALDT on a case-by-case basis.

6.43 Acknowledging that the ALDT is ultimately based on the facts and circumstances of each case, the Board notes that case studies are nonetheless useful for those having to apply the rules, particularly in terms of which particular ratios have more weight for particular industries.

Recommendation 5

The Board recommends that:

- additional administrative guidance be provided, using case study examples to illustrate how to apply the ALDT across different industries, without detracting from the required flexibility in applying the ALDT on a case-by-case basis; and
- while it is acknowledged that information would vary for each taxpayer and industry, administrative guidance should also detail the data sources the ATO typically refers to when applying the ALDT.

ADDITIONAL SAFE HARBOURS BASED ON EARNINGS

6.44 The discussion paper sought feedback on one stakeholder's suggestion that there should be an additional safe harbour test based on earnings rather than assets (such as the EBITDA test used for related-party debt in the US) as an alternative to the existing tests for debt-to-asset safe harbour, arm's length and worldwide gearing.

Views in submissions

6.45 A number of stakeholders supported the introduction of an additional safe harbour based on earnings, such as a set percentage of EBITDA.

6.46 AVCAL supports the creation of an additional safe harbour test based on EBITDA, as it would assist industries that are not capital-asset intensive (for example, services) and that may be 'significantly disadvantaged by the safe harbour tests on the basis that material assets such as internally generated goodwill may not be recognised for accounting purposes.' AVCAL added that:

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

6.47 EY also supported the introduction of a second (and alternative) safe harbour test based on a set percentage of EBITDA, which would assist those taxpayers for which the current safe harbour test is inappropriately restrictive, but which may objectively warrant a higher gearing level based on cash flows. It suggested that an appropriate level would need to be developed in consultation with stakeholders.

6.48 PwC also supported the introduction of an additional safe harbour test based on earnings, such as EBITDA. In addition, as an alternative to the current asset-based test, it suggested using the capital structure of the global or worldwide group, such that the interest expense would be fully deductible if the taxpayer had a debt-to-asset ratio equal to or lower than the global debt-to-asset ratio, based on the worldwide consolidated balance sheet. It also proposed that the non-deductible portion of the interest expense under the safe harbour test should be allowed to be carried forward indefinitely.

6.49 The PCA supported the introduction of additional safe harbour tests, as long as they do not limit or remove access to the current safe harbour tests. It cautioned about the difficulties in defining an additional safe harbour test:

> '… There are considerable difficulties in determining one ratio type (and ratio level) that can be applied across to all taxpayers participating in different industries and even within different sectors of the property industry. Additionally, appropriate ratio levels will necessarily move over time due to economic factors and fluctuations in the debt markets (amongst other things)'.

6.50 A confidential submission did not support the introduction of an EBITDA-based test as a replacement for the current safe harbour test. It noted that as a result of large volumes of financial hedging, significant differences can appear between tax and accounting values at the EBITDA line.

6.51 Another confidential submission argued that for the post-construction phase of large capital-intensive projects, an additional safe harbour test may be beneficial. It noted that for such projects, the assets diminish due to depreciation and amortisation, potentially decreasing the ALDT, whereas an earnings ratio would look at the strength of earnings of the project (that is, returns on those assets) rather than an arbitrary measure based on historical cost.

6.52 Other stakeholders expressed reservations on the merits of introducing an additional safe harbour test based on EBITDA.

6.53 CPA Australia did not support the introduction of additional safe harbour tests based on earnings, as it would be difficult to apply any single test across all industries:

> 'We do not support the proposal that additional safe harbour tests based on earnings should be incorporated in the ALDT as we are concerned that there could be too much variance in earnings metrics between different industries for any generalised safe harbour tests to be reliably developed'.

6.54 Deloitte similarly argued that it would be difficult to come up with and agree on particular ratios that are suitable for a wide range of industries. It added that more specific ratios for each industry would result in uncertainty as to which industry a taxpayer relates to. It argued that better guidance by way of case study examples would better assist with much less complexity and controversy.

6.55 CAANZ noted that further work would be needed to determine the efficacy of an EBITDA test.

The Board's consideration

6.56 If an additional safe harbour test would assist by readily reducing the administrative burden and compliance cost for taxpayers by reducing the number of taxpayers needing to access the ALDT in clear cases, this is within the scope of the review. However, the Board does not consider that this would be the result of introducing such an additional EBITDA-based safe harbour test. Indeed, the Board is of the view that the introduction of such an additional safe harbour would merely add complexity and would be of limited application.

6.57 That said, the current asset-based approach of the safe harbour rules favours asset-based industries such as the infrastructure and property industries. This is in contrast with non–asset intensive industries such as services industries with significant amounts of internally generated goodwill or intangibles not recognised on their balance sheets but with strong cash flows. An alternative safe harbour test based on earnings would seemingly be most relevant for those businesses that typically need to rely on the ALDT based on their cash flows and capacity to service debt.

6.58 The Board considers that, rather than introducing an additional EBITDA-based safe harbour, an EBITDA test could be used as part of administrative guidance including to illustrate circumstances where there has not been relevant material change affecting the lending. Administrative guidance could provide further discussion and possible examples of the appropriateness of various 'profit level indicators', including EBITDA. There may be instances and scenarios where EBITDA might be given greater weighting, such as in service industries and some situations where it may not be given the same weighting, such as in capital-intensive businesses. The Board also considers that using case studies would help illustrate the metrics that should be measured (for example, industry, size and other suitable metrics).

Recommendation 6

Although the Board does not support the introduction of an alternative earnings-based safe harbour test, the Board recommends including an EBITDA test as part of administrative guidance, to illustrate circumstances where there has not been a material change affecting the lending and where, if certain metrics are satisfied, the ALDT requirements continue to be met.

The administrative guidance could also address the use of certain metrics and the weightings in certain industries. The Board considers that this could significantly reduce the amount of work required when applying the ALDT.

EXTENT OF REQUIRED ALDT ASSESSMENT WHEN THERE IS NO RELATED-PARTY DEBT

6.59 In the discussion paper some stakeholders argued that where the relevant debt interest is wholly debt that has been borrowed and lent between independent arm's length parties, the potential integrity concerns that arise are different from circumstances where there are debt arrangements between related parties.

6.60 These stakeholders suggested that the integrity concerns may be limited to the existence of credit support from associates and the terms of any back-to-back lending.

6.61 The paper also noted that there may be circumstances where the fact that an entity is a shareholder or an equity interest holder may be sufficient to qualify them as a related party of the debtor, so that 'extended' integrity tests should apply in determining the arm's length debt amount.

6.62 The thin capitalisation legislation does not in fact include a concept of 'related-party debt'. As the *Income Tax Assessment Act 1936* (Cth) (ITAA 1936) and the ITAA 1997 are primarily concerned with parties that are 'associates' (as defined in those Acts), 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) to ascertain whether extended integrity tests should apply in determining the arm's length debt amount.

6.63 Against the above background, the Board sought stakeholders' comments on whether there was scope to simplify the ALDT when there is no related-party (or associate) debt. The Board asked whether the concept of related-party debt requires additional clarification for these purposes and, if so, how. The Board also questioned what integrity concerns would need to be addressed in those circumstances.

Views in submissions

6.64 Stakeholders generally supported less onerous requirements for entities where the debt profile does not include any related-party debt.

6.65 PwC submitted that taxpayers funded entirely with third-party debt and with no explicit credit support from associates should be exempt from needing to prepare documentation to support the application of the ALDT.

6.66 CAANZ also supported simplifying the ALDT where there is no related-party debt and no parent guarantees or other forms of explicit credit support.

6.67 Deloitte submitted that where all the debt is provided by arm's length parties and relates to an Australian business, the ALDT should be satisfied.

6.68 AVCAL argued that the exclusion from the thin capitalisation rules would be particularly appropriate for inbound groups that have no foreign assets or business under their Australian entities, and do not have any express or implicit support from their foreign parents.

6.69 The PCA argued that there should be no need to undertake a prescriptive transfer pricing–style analysis where a taxpayer only has debt provided by unrelated commercial lending institutions or the debt is raised in the capital markets and is only secured against Australian property.

6.70 EY submitted that when there is no related-party debt, the ALDT analysis should be limited to an enquiry as to whether (i) the Australian entity has benefited from any credit support from its international related parties, and/or (ii) the value and/or projected cash flow of the controlled foreign business of the Australian entity have impacted upon its reasonable debt levels. It argued that if the answer is no, the ALDT should be taken to be satisfied.

6.71 A confidential submission also supported simplifying the ALDT for transactions involving non–related party debt. However, this submission acknowledged that some integrity concerns may still exist when there is non–related party debt, such as the potential for debt funding to be at an inappropriately high level to fund offshore business that is not subject to Australian tax.

6.72 AVCAL submitted that the ALDT should assess whether an entity is a related party of the taxpayer rather than an associate (or similar). It noted that there may be common passive investors in a private debt fund and a private equity fund that have lent and invested in a company, and that it would be onerous for the company to investigate and confirm all potential associations between the providers of equity and debt.

6.73 In particular, AVCAL noted that developing a separate ‘related party’ concept could alleviate issues associated with tracing and testing where lenders of mezzanine debt funding take a small equity stake in the arrangement.

6.74 Mezzanine debt funding is often structured with attached warrants or equity conversion features, used in conjunction with senior debt financing. AVCAL stated that mezzanine lenders are commercial lenders in their own right and the mere fact that a third-party debt fund commonly holds a small proportion of equity-like instruments in the taxpayer should not be sufficient to classify this financing as related-party debt for the purposes of the ALDT.

6.75 In an alternative view, Pitcher Partners submitted that the definition of external borrowings for the purpose of the ALDT should be any sum borrowed from an entity that is not an ‘associate’, with this term as defined in section 318 of the ITAA 1936. CAANZ also supported this definition of ‘associate’ in identifying related-party debt.

6.76 Pitcher Partners further submitted that all middle-market taxpayers with external borrowings should automatically pass the ALDT and, if that was not accepted, at the very least middle-market taxpayers should be allowed to perform the ALDT on a consolidated 'family group' basis, as defined in the Trust Loss Rules (section 272-90 in Schedule 2F of the ITAA 1936). CAANZ also suggested that small and medium enterprises (SMEs) should be permitted to apply the ALDT on a consolidated 'family group' basis.

The Board's consideration

6.77 The Board agrees with the view that less onerous compliance requirements should apply to entities with a debt profile that does not include any associate-party debt. Equally, the Board is of the view that less onerous compliance requirements should apply to entities that have only an Australian business; have no foreign assets or businesses under their Australian entities; do not receive any support from their foreign parents or associates; and are not engaged in back-to-back arrangements.

6.78 In line with the above, the Board recommends that guidance in the application of the ALDT should allow for graduated compliance requirements according to the integrity risks posed by the entity that is subject to the ALDT assessment.

6.79 At one extreme, an entity that only conducts an Australian business in which the funding is used, with no debt funding or support from a related party, should be considered a low tax-integrity risk and face limited ALDT compliance enquiries. In this case, the ALDT-related inquires may be restricted to confirm whether funding is genuinely from third-party lenders, with no back-to-back arrangements or guarantees provided by foreign parents or associates.

6.80 At the other extreme, an entity that has activities not exclusively related to its Australian business, with debt funding from related parties and support from foreign parents or associates, should be considered a high tax-integrity risk and face more extensive ALDT compliance enquiries. In this case, the ALDT-related enquiries would continue to apply substantially as they currently do. The ALDT analysis would also need to establish whether the funding from related parties and support from foreign parents or associates have enabled or influenced obtaining an amount of debt that is excessive with respect to the funding needs of the Australian-only business.

6.81 In between those extremes there would be medium tax-integrity risk for entities that are funded by non–related party debt but have activities not exclusively related to an Australian business. The ALDT-related compliance enquiries would also need to establish whether the level of funding obtained is excessive with respect to the funding needs of the Australian-only business.

6.82 The Board acknowledges that to the extent the ALDT-related compliance enquiries would depend on establishing whether funding has been provided by foreign parents or associates, there might be circumstances where identifying the absence of funding provided by associated parties might be difficult, as it would involve complex tracing of the ultimate providers of funding.

6.83 Acknowledging that investigating all potential associations between the equity and debt providers might be difficult in some cases, the Board considers that introducing a new and alternative concept of 'related parties' in the thin capitalisation legislation is not desirable. To do so it might be expected to create additional complexities and uncertainties in interactions with other parts of the tax law.

6.84 The Board does favour the ATO providing updated administrative guidance addressing anomalies that arise for certain financing arrangements — including, for example, funding provided by associates and mezzanine debt.

6.85 The Board acknowledges that the existing concept of 'associate' (which in this context looks to whether a lender has sufficient influence over the borrower) depends on the particular facts and circumstances of each case and causes a high degree of uncertainty in practice. The Board understands that the ATO is currently developing administrative guidance to clarify the application of 'sufficient influence' under the associate test in section 318 of the ITAA 1936 in the context of stapled groups. The Board considers that the principles in this guidance may be useful, and stakeholders should consult with the ATO to ensure their concerns are addressed as this guidance is developed.

6.86 In relation to the impact on family groups and SMEs, the increase in the *de minimis* threshold from $250,000 to $2 million of debt deductions is expected to provide appropriate relief from thin capitalisation compliance requirements for small businesses. The Board does not support the introduction of additional rules for family businesses or SMEs, as changes to the thin capitalisation *de minimis* should alleviate their issues.

6.87 The Board further notes that the ALDT is applied on a per-entity basis. As such, it does not allow taxpayers to perform the ALDT on a non-consolidated 'family group' basis, as this could also compromise the integrity of the provisions.

Recommendation 7

The Board recommends that, based on the tax integrity risk framework:

- guidance for applying the ALDT should allow graduated compliance requirements according to the integrity risks posed by the entity that is subject to the ALDT assessment. By way of example:
  - an entity conducting Australian business only, with no debt funding or support from a related party, should be considered a low tax-integrity risk and should face limited ALDT compliance enquiries;
  - an entity with activities not exclusively related to an Australian business, with debt funding from related parties and support from their foreign parents or associates should be considered a high tax-integrity risk and should face more extensive compliance enquiries substantially in keeping with the current application of the ALDT;
  - entities that are funded by non–related party debt but have activities not exclusively related to an Australian business — and those that are funded with related-party debt but have exclusively Australian businesses — would need to establish whether the level of funding obtained is excessive with respect to the funding needs of the Australian-only business; and
- the guidance should clarify the concept of 'associate' and, in particular, the circumstances in which a lender has sufficient influence over the borrower for the purposes of the ALDT.

SEPARATE BORROWER AND LENDER TESTS AND THE APPLICATION OF RELEVANT FACTORS

6.88 The discussion paper noted that taxpayers that use the ALDT must consider the test from the borrower and lender perspective. The borrower test has regard to the debt capital an Australian business would reasonably be expected to have throughout an income year, while 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.

6.89 The discussion paper noted that it is often difficult to determine the amount that an entity would reasonably be expected to borrow compared to what the entity could borrow (that is, what a commercial lending institution would lend). The relevant factors might be weighted differently when applying the borrower and the lender elements of the ALDT.

Views in submissions

6.90 Stakeholders were somewhat divided in their submissions regarding the practicality of applying separate borrower and lender tests, and how this could be simplified while retaining the integrity of the rules.

6.91 Some stakeholders commented that it is often difficult to distinguish between an amount that an entity would reasonably be expected to borrow and the amount the entity could reasonably be expected to borrow, based on what an independent lender would be expected to lend.

6.92 Deloitte noted that there are some differences between the 'would' and 'could' elements of the borrower and lender tests. However, they noted that, based on the current guidelines, there is a large degree of overlap that leads to potential duplication.

6.93 PwC and CAANZ both stated that the independent borrower test 'suffers from some practical limitations including sensitivity to recognition and/or valuation of assets and equity capital'. PwC noted that this is 'common to any transfer pricing analysis involving the application of profit-based methods'.

6.94 In support of retaining the independent borrower test, CAANZ stated that the test is an 'important integrity provision', while PwC noted that the test is:

> '… based on sound economic principles, works reasonably well in practice, is widely understood and accepted from a transfer pricing perspective, and there would not appear to be a realistic alternative option available'.

6.95 While PwC and CAANZ both support retaining the test, they do acknowledge that there is some scope for simplification. CAANZ suggested this could be achieved by removing the requirement for annual testing when there is no material change in the relevant income year, and allowing the tests to be applied using forecast financial data.

6.96 Noting the uncertainty, both Deloitte and the CPA suggested that the independent lender test should become the primary test for satisfying eligibility under the ALDT. The independent lender test assesses the amount that an entity could potentially borrow from a commercial lending institution on an arm's length basis, and the independent borrower test could be read down.

6.97 A confidential submission noted that the independent borrower and lender tests are both very complex and require significant effort to complete. The submission noted that it would be difficult to see how these rules could be simplified while a large number of parameters exist in the legislation, forcing an artificial background to determining the independent borrower and lender amounts.

6.98 A confidential submission also noted that the parameters of the legislation make the distinction difficult in the ALDT analysis. The submission noted that for large capital raisings, businesses generally go to market seeking a certain level of debt, and plan for alternatives in case there is no appetite to provide the required debt — or the terms or pricing do not meet the borrower's requirement. These would be the amounts the borrower would reasonably be expected to borrow. To the extent businesses are required to artificially impose constraints in applying the ALDT, the borrower will likely seek all available means to acquire the level of debt required. That is, the targeted borrowings should not change just because the borrowings were set at a level to maximise value to shareholders and ensure the investment can proceed.

The Board's consideration

6.99 The Board considers that is it appropriate to retain both the independent borrower and independent lender tests given the objective of determining the arm's length level of debt. In principle, applying only the independent commercial lender test could provide an objective answer as to the amount the borrower would reasonably be expected to borrow. However, the independent lender and independent borrower would have different commercial objectives and risk appetites as indicated by the actual debt levels of independent borrowers.

6.100 Accordingly, it is appropriate to retain the independent borrower test, to provide a level of rigour and integrity in determining the arm's length debt amount. The Board notes that the ATO expects independent borrowers to act in an economically rational manner. The independent borrower should not only strive to earn a level of operating profits that service its debts, it should also provide an adequate return for its shareholders, based on an arm's length capital structure given the risk in its business and the volatility of returns.

6.101 The Board considers that it would be beneficial for the ATO to provide appropriate administrative guidance to illustrate how these tests should be applied in practice. Administrative guidance should acknowledge some of the factors that are particularly relevant for the independent borrower test, compared to the independent lender test. The administrative guidance should include further examples of how to apply the test, including the type of evidence that would be required to meet the test under alternative scenarios to assist taxpayers in applying the ALDT.

6.102 The Board notes that, as part of administrative guidance on the application of the relevant factors, reference could be made to clarifying the relationship between the ALDT and transfer pricing concepts, including confirming that the transfer pricing rules have to be met prior to applying the ALDT.

Recommendation 8

The Board recommends that:

- Additional administrative guidance be provided to better illustrate how the independent borrower and independent lender tests should be applied.
- The additional administrative guidance should also illustrate which factors should be given greater weighting regarding the borrower elements of the test — for example, considering the debt levels and return on equity (ROE) of comparable companies. Industry comparable data may be relevant for the borrower test and the lender test; ultimately, this will depend on the facts and circumstances of each case.
- Additional administrative guidance be provided to illustrate the relationship between the ALDT and the transfer pricing rules in Division 815 of the ITAA 1997.

TIME TO SUBMIT SUPPORTING ALDT DOCUMENTATION

6.103 As noted in the discussion paper, documentation supporting the ALDT needs to be completed by the due date for lodging an income tax return.

Views in submissions

6.104 Several submissions called for an extension of time allowed to prepare the ALDT documentation. Some submissions also called for the removal of time limits on preparing ALDT documentation. In addition to the push for an extension of time to prepare documentation, a number of stakeholders suggested that administrative shortcuts should be available to assist with the preparation of ALDT documentation.

6.105 The PCA noted that an extension of time should be consistent with transfer pricing rules where there is no time limit for documentation submissions, but taxpayers that do maintain contemporaneous documentation enjoy protection from penalties.

6.106 EY and AVCAL called for taxpayers to have a reasonable period of time after the end of the year in which the ALDT analysis is required, allowing them to prepare supporting documentation.

6.107 The ABA requested legislative or administrative clarity to remove any doubt about whether taxpayers can rely on the ALDT for any open year of income, especially in circumstances where taxpayers have had to rely on the alternative thin capitalisation tests after the ATO has challenged an existing thin capitalisation position. AVCAL equally shared this view, stating that because the ALDT is only considered when the safe harbour tests fail, there may be circumstances where the ALDT is not required until a period of time has elapsed. Accordingly, the timing requirements for preparing the ALDT should allow for such circumstances.

6.108 The Board received various suggestions on ways to reduce compliance costs associated with preparing ALDT documentation. The ABA recommended that a legislative mechanism or administrative shortcut should be provided, which could have regard to the typical level of debt funding used in different industry segments.

6.109 A confidential submission stated that preparing documentation to support the ALDT calculation is extensive and costly, but the ability to request an extension of time to complete the documentation (for example, a six-month extension) without penalty, based on reasonable justification, would assist taxpayers involved in very complex arrangements.

The Board's consideration

6.110 Under the existing tax law, taxpayers can use any available method in the thin capitalisation rules to calculate their allowable debt deductions. This applies regardless of whether taxpayers fail to prepare documentation in support of their analysis or if they prepare the documentation after lodging their income tax return.

6.111 Failure to prepare documentation on time will, however, leave the taxpayer open to the possibility of the Commissioner applying an administrative penalty. The penalty is 20 penalty units, and a penalty unit is currently set at $170.[45]

6.112 The Commissioner may impose an administrative penalty, in accordance with section 288-25 of Schedule 1 to the *Taxation Administration Act 1953*, where a provision of a taxation law requires an entity to keep or retain records and the entity does not keep or retain records in a manner required by that taxation law.[46] The Commissioner may choose to remit part or all of a record-keeping penalty.[47]

6.113 The Board recommends that legislative amendment in respect of relevant penalties is not presently warranted. This would potentially change if the Commissioner were to seek to apply a penalty, other than an administrative penalty, because documentation supporting the ALDT had not been executed before the due date for lodging an income tax return.

6.114 The Board considers that it would be beneficial and sufficient to develop appropriate administrative guidance illustrating how the Commissioner could apply an administrative penalty.

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45 The value of a penalty unit is set by subsection 4AA(1) of the Crimes Act 1914. The value of $170 applies for contraventions occurring on or after 28 December 2012. For contraventions occurring before that date, the value of a penalty unit is $110.

46 ATO, Practice Statement Law Administration PS LA 2005/2: Penalty for failure to keep or retain records.

47 Section 298-20 of Schedule 1 to the Taxation Administration Act 1953.

Recommendation 9

The Board recommends that additional administrative guidance be provided to remove taxpayers' doubts about their ability to rely on the ALDT for any open year of income, irrespective of when supporting documentation is prepared.

ENSURING GUIDANCE FOR SPECIAL-PURPOSE VEHICLE EXEMPTION ACHIEVES ITS OBJECTIVE

6.115 The discussion paper noted that an ATO interpretative decision relating to an exemption from the thin capitalisation rules for certain special-purposes entities unduly restricted ALDT access for a range of securitisation vehicles that are fully or almost fully funded by third-party debt, and on-lent on back-to-back terms. Arguably, these structures are neither tax-driven nor do they present a tax advantage, but they are used to provide a liquidity mechanism for debt providers, and can be useful to facilitate the financing of infrastructure projects.

6.116 The interpretative decision was withdrawn on 9 May 2013 and a final taxation determination, TD 2014/18, was issued on 2 July 2014. TD 2014/18 states that the exemption in section 820-39 of the ITAA 1997 can apply to a special-purpose entity seeking finance for a project that is established as part of the securitised licence structure used in some social infrastructure public–private partnerships (PPPs), provided that the special-purpose entity satisfies the conditions in subsection 820-39(3) of the ITAA 1997.

Views in submissions

6.117 Both PwC and Deloitte considered that further guidance is required to clarify when the carve-out from the thin capitalisation rules applies for securitisation, project finance and other vehicles predominantly financed by third-party debt (particularly where the finance is lent on back-to-back terms to the entity subject to the thin capitalisation rules).

6.118 CAANZ submitted that it did not consider there was a need to provide further guidance on the exemption from the thin capitalisation rules for certain special-purpose vehicles provided by section 820-39 of the ITAA 1997, given that TD 2014/18 has removed the uncertainty in this area. However, CAANZ noted that the taxation determination applied to securitised licence structures used in social infrastructure PPPs, but excluded other genuine securitisation vehicles. CAANZ suggested that the TD could be amended to state that 'the principles that apply in the TD equally apply to other types of special-purpose entities and are not limited to special-purpose entities used in social infrastructure PPPs'. In the absence of such an amendment, the CAANZ stated that a new TD should be drafted to include non-PPP securitisation structures.

The Board's consideration

6.119 The Board confirmed through consultation that the final TD resolved stakeholder concerns with the draft TD, and that the application of section 820-39 was no longer in contention.

6.120 The Board notes that the ATO has finalised the TD and has not extended it to include non-PPP securitisation structures. The Board understands that the ATO has encouraged stakeholders to approach it with examples of different scenarios they consider should be covered by the exemption in section 820-39 of the ITAA 1997.

Observation 4

The Board notes that the application of section 820-39 of the ITAA 1997 is no longer in contention following the release of TD 2014/18.

While some stakeholders expressed a view that the TD should be extended to include non-PPP securitisation structures, the Board notes that the ATO has encouraged stakeholders to approach it with examples of different scenarios, demonstrating how and why the exemption in section 820-39 of the ITAA 1997 should apply. Accordingly, the ATO might be able to provide further guidance in respect of any alternative scenarios once it has reviewed further examples.

FUTURE REVIEW OF ATO GUIDANCE MATERIAL

6.121 The ATO's education, guidance and advisory role allows it to respond to stakeholder concerns through its own administrative practices. The Board commends the ATO's willingness to provide more extensive guidance, and to develop a tax integrity risk assessment framework (see Chapter 3, Table 1) when applying the ALDT going forward.

6.122 The Board acknowledges that to the extent that the current environment and commercial landscape changes, the ATO's administrative guidance may become irrelevant in the future. Changes could arise as a result of the base erosion and profit-shifting project being completed on a global level, or due to changes in the Australian business environment more generally. Accordingly, the Board recommends a further review in the mid-term future, in the event that it appears the ATO's administrative guidance is no longer appropriate.

Recommendation 10

The Board recommends a further review be conducted in three years, in the event that it appears the ATO's administrative guidance on the ALDT is no longer appropriate.

APPENDIX A: SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

Observation 1

The Board observes that a 'tax integrity risk framework' approach to applying the ALDT helps identify the scenarios where it may be possible to significantly reduce the compliance cost for taxpayers and the administrative burden for the ATO.

Observation 2

The Board observes that identifying and isolating the Australian business and Australian assets can be problematic for a very limited number of taxpayers in certain industries. The question of whether business carried on through an overseas permanent establishment should be re-included in the definition of 'average Australian assets' is a fundamental question of Government policy and so is not a matter on which the Board is in a position to make a recommendation.

Observation 3

The Board considers that ATO officers should be provided with sufficient training and expertise to deal with technical issues that require the exercise of judgment regarding the ALDT. In this respect, the Board observes that ATO officers could receive additional training to ensure they have the appropriate capabilities.

Observation 4

The Board notes that the application of section 820-39 of the ITAA 1997 is no longer in contention following the release of TD 2014/18.

While some stakeholders expressed a view that the TD should be extended to include non-PPP securitisation structures, the Board notes that the ATO has encouraged stakeholders to approach it with examples of different scenarios, demonstrating how and why the exemption in section 820-39 of the ITAA 1997 should apply. Accordingly, the ATO might be able to provide further guidance in respect of any alternative scenarios once it has reviewed further examples.

Recommendation 1

Subject to the adoption of all other recommendations in this report, the Board recommends that:

- there should be no limitation on taxpayers that are eligible to access the ALDT; and
- in particular, access should not be restricted by a mandatory advanced ruling or determination system.

Recommendation 2

The Board recommends that:

- the ALDT legislative assumptions be amended so that explicit credit support is not required to be excluded for the purposes of calculating the allowable level of debt deduction, where the nature of the loan and of the explicit credit support is such that although the type of explicit credit support provided would generally be required by an independent commercial lender, it would not affect the amount of debt the borrower could access, and the entity can sustain the level of debt on a stand-alone basis; and
- the ALDT legislative assumptions should be amended so that implicit credit support does not have to be excluded for the purposes of calculating the allowable level of debt deduction.

Recommendation 3

The Board recommends that the ATO develop updated administrative guidance, consistent with the tax risk integrity framework, to enable reduced testing and verification of the ALDT requirements. In this respect, the guidance should require that taxpayers only need to assess that no material change occurred during the income year that would change the result of their analysis under the framework.

Given the focus on 'material change', the Board also recommends that the updated administrative guidance include a series of focusing questions based on changes to (i) the entity or its Australian business, (ii) the features related to debt and (iii) the relevant business environment, to help taxpayers determine when a 'material change' has occurred.

Recommendation 4

The Board recommends no changes to the existing process, and that taxpayers who wish to obtain certainty with respect to their thin capitalisation positions should continue to have the option of obtaining a private binding ruling, with no need to introduce ATCAs.

Recommendation 5

The Board recommends that:

- additional administrative guidance be provided, using case study examples to illustrate how to apply the ALDT across different industries, without detracting from the required flexibility in applying the ALDT on a case-by-case basis; and
- while it is acknowledged that information would vary for each taxpayer and industry, administrative guidance should also detail the data sources the ATO typically refers to when applying the ALDT.

Recommendation 6

Although the Board does not support the introduction of an alternative earnings-based safe harbour test, the Board recommends including an EBITDA test as part of administrative guidance, to illustrate circumstances where there has not been a material change affecting the lending and where, if certain metrics are satisfied, the ALDT requirements continue to be met.

The administrative guidance could also address the use of certain metrics and the weightings in certain industries. The Board considers that this could significantly reduce the amount of work required when applying the ALDT.

Recommendation 7

The Board recommends that, based on the tax integrity risk framework:

- guidance for applying the ALDT should allow graduated compliance requirements according to the integrity risks posed by the entity that is subject to the ALDT assessment. By way of example:
  - an entity conducting Australian business only, with no debt funding or support from a related party, should be considered a low tax-integrity risk and should face limited ALDT compliance enquiries;
  - an entity with activities not exclusively related to an Australian business, with debt funding from related parties and support from their foreign parents or associates should be considered a high tax-integrity risk and should face more extensive compliance enquiries substantially in keeping with the current application of the ALDT;
  - entities that are funded by non–related party debt but have activities not exclusively related to an Australian business — and those that are funded with related-party debt but have exclusively Australian businesses — would need to establish whether the level of funding obtained is excessive with respect to the funding needs of the Australian-only business; and
- the guidance should clarify the concept of 'associate' and, in particular, the circumstances in which a lender has sufficient influence over the borrower for the purposes of the ALDT.

Recommendation 8

The Board recommends that:

- Additional administrative guidance be provided to better illustrate how the independent borrower and independent lender tests should be applied.
- The additional administrative guidance should also illustrate which factors should be given greater weighting regarding the borrower elements of the test — for example, considering the debt levels and return on equity (ROE) of

comparable companies. Industry comparable data may be relevant for the borrower test and the lender test; ultimately, this will depend on the facts and circumstances of each case.

- Additional administrative guidance be provided to illustrate the relationship between the ALDT and the transfer pricing rules in Division 815 of the ITAA 1997.

Recommendation 9

The Board recommends that additional administrative guidance be provided to remove taxpayers' doubts about their ability to rely on the ALDT for any open year of income, irrespective of when supporting documentation is prepared.

Recommendation 10

The Board recommends a further review be conducted in three years, in the event that it appears the ATO's administrative guidance on the ALDT is no longer appropriate.

APPENDIX B: LIST OF PUBLIC SUBMISSIONS

The Board received 12 submissions as part of the review, including two confidential submissions. The following organisations made public submissions; these submissions are available online at www.taxboard.gov.au.

Australian Bankers Association

Australian Private Equity & Venture Capital Association Limited

CPA Australia

Deloitte

EY

Chartered Accountants Australia and New Zealand

Pitcher Partners

Property Council of Australia

PwC

The Tax Institute