



AUSTRALIAN BANKERS'
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14 March 2014

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

Dear Elizabeth,

Review of the Thin Capitalisation Arm's Length Debt Test

We refer to the Board of Taxation's (**Board**) Discussion Paper titled "*Review Of The Thin Capitalisation Arm's Length Debt Test*" (**Review**) released in December 2013. The stated purpose of the Review, in accordance with the Board's terms of reference, is broadly to consider ways in which the ALDT could be amended so as to reduce compliance costs for taxpayers and ATO alike and to assess the appropriateness of the existing eligibility criteria.

The Australian Bankers' Association (**ABA**) is the peak national body representing banks that are authorised by the Australian Prudential Regulation Authority (**APRA**) to carry on banking business in Australia. The ABA's membership of 24 banks comprises the four major banks, former regional banks that now operate nationally, foreign banks that are represented and carry on banking business in Australia as Australian banks and a mutual bank.

The ABA welcomes the opportunity to comment on the Discussion Paper and our specific comments are outlined below.

1. Reduced Tax Compliance Costs

The Discussion Paper outlines a number of measures aimed at reducing compliance costs for taxpayers. The ABA is supportive of the following measures:

- Removing the requirement of annual testing such that taxpayers would only be required to document its compliance with the ALDT at the time when initial reliance on the test is sought, with subsequent testing limited to every five years or where a material change of circumstances arises. In 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%. Organic growth or contraction of a business should not be considered a material change.
- Removing any doubt that taxpayers have the ability to rely on the ALDT for any open year of income, even where taxpayers have sought to rely on an alternative thin capitalisation test in lodging its relevant income tax return. This will be particularly relevant where the Australian Taxation Office (ATO) seeks to challenge a taxpayer on its thin capitalisation position, which would typically involve interpretation issues on the operation of the safe harbour test. It is understood that the ATO would normally allow additional time for the preparation of the ALDT documentation for any open year of

income, despite the wording of Section 820-980(3), which requires the taxpayer to have prepared the documentation prior to the tax return lodgement date for the particular year of income.

- The ALDT should also ideally provide a legislative mechanism whereby short cut methods of documentation will be considered acceptable for the purposes of the test. In the absence of specific legislative short cuts, the ATO should also provide a range of administrative short cuts that are designed to reduce the cost of compliance for taxpayers, while maintaining appropriate integrity in the underlying ALDT. Such short cuts could also have regard to the typical level of debt funding used in different industry segments.

2. Access to Arm's Length Debt Test

In relation to eligibility to the ALDT, the ABA is of the view that the test should not be amended in any manner that would restrict its availability to taxpayers. Given the proposed changes to the safe harbour test (to reduce the acceptable level of gearing from 3:1 to 1.5:1) it is likely that more taxpayers will seek to rely on the ALDT going forward.

As a result, if there is a simultaneous tightening of the eligibility criteria for the ALDT this may have the effect of unnecessarily restricting taxpayers' ability to use debt funding, even where that third party lender is willing to provide the required funding on arm's length terms. The ABA considers this would be an undesirable outcome that could unnecessarily drive up the cost of debt funding for Australian business.

3. Arm's Length Capital Test

ABA members will typically not be directly impacted by the ALDT as the particular test is not relevant for Authorised Deposit Taking Institutions (ADIs). In the case of ADI's an equivalent arm's length capital test (ALCT) exists and this alternative will be most relevant in the event that an ADI is unable to satisfy the safe harbour capital test in Section 820-310.

The ABA considers that as the ALCT operates in a similar manner to the ALDT, any compliance concessions developed as a result of the Review should be equally applicable to the ALCT, including the specific recommendations discussed in Section 1 above.

The arm's length capital test provides ADIs with an alternative to the safe harbour test contained in section 820-310. Despite this ADI's have typically not sought to rely on the ALCT favouring the apparent certainty and easier compliance requirements associated with the safe harbour capital test. However in recent times, the ATO has challenged the operation of the safe harbour capital test for ADI's in particular the application of the test to banking group's that also have other non-banking operations, such as life insurance and funds management activities.¹ The ABA notes that the introduction of Level 3 APRA capital standards would provide an opportune time for a review of the current thin capitalisation legislation and to ensure the legislation meets its original policy intent to link a diverse ADI group or Non-Operating Holding Company's (NOHC's) thin capital requirements to its APRA regulatory requirements.

In the absence of a full legislative solution linking to the Level 3 capital standards as ultimately introduced the ABA is strongly of the view that a short cut ALCT framework should be developed for ADIs to make the ALCT more accessible and to reduce the compliance costs inherent in the current rules. One possible short cut method for the ALCT for banking/life company groups and NOHC's would be to determine the arm's length capital amount by using a variation of the safe harbour test.

¹ Difficulties have arisen for ADIs in applying the safe harbour test due to the ATO's view on the application of the rules for a tax consolidated group containing an ADI. The ATO views are set out in ATO ID 2010/86 and ATO ID 2010/87 and can result in a well-capitalised ADI failing the safe harbour capital tax due to life company policyholder assets being notionally considered to be held by the ADI.

Under such a test the arm's length capital amount would be the sum of the capital requirements of the ADI banking group determined on a level 2 basis (using the ADI safe harbour capital test) and the capital requirements of the non-banking group (using the safe harbour test applicable to a general corporate or financial entity). Such a short cut method was recently discussed in a paper prepared by KPMG² and the relevant extract of this paper is set out in Attachment A.

Overall the ABA is supportive of measures designed to make both the ALDT and ALCT more accessible to taxpayers, provided that this could be achieved without any increase in the cost of compliance. We also believe that the introduction of either legislative or administrative short cut methods of compliance should help facilitate such outcomes.

Yours sincerely,



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² Taxation of life companies. Reflections on the 2000 reforms, pages 28 – 31, presented at the Financial Services Conference – February 2014