

14 March 2014

Ms Elizabeth Jameson
The Board of Taxation
C/- The Treasury
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Email: taxboard@treasury.gov.au

Dear Ms Jameson,

Review of the Thin Capitalisation Arm's Length Debt Test

Thank you for the opportunity to comment on the thin capitalisation arm's length debt test.

The Property Council is the peak body representing the interests of owners and investors in Australia's \$670 billion property investment industry. The Property Council represents members across all four quadrants of property investment, debt, equity, public and private.

The Property Council welcomes the Board of Taxation's discussion paper on ways to make the arm's length debt test more effective by reducing compliance costs for business and making it easier for the ATO to administer.

Previous discussions with the Board of Taxation had reassured industry that the reforms contemplated would only simplify administration and make it clearer how the existing test applies.

The current review seems to contemplate changes to the applicability of the existing arm's length debt test and industry is concerned that the review will limit access to the test.

The arm's length debt test itself should not be restricted in any way. Any amendments to the broader rules should simply enhance the administration and equity of the existing test.

The arm's length debt test was introduced to protect legitimate transactions that are geared with commercial arm's length debt in excess of the safe harbour limits.

With the proposed reduction in the safe harbour thresholds, it is even more critical that an arm's length debt test is preserved as a practical safeguard.

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For example, critical projects may have arm's length debt in excess of the safe harbour limit during the construction phase, but once they are completed, the increased property value brings the debt levels within safe harbour limits.

Without the arm's length debt test, the viability of these projects is at risk, even though investors are willing to lend above the safe harbour threshold. This is unfair and impractical.

Limiting access to the arm's length debt test will impose an artificial barrier on the amount of debt capital that would otherwise be available for property investments.

Industry supports amendments to the arm's length debt test that will simplify the administration of the rules and align the test more closely with commercial borrowing practices.

In particular:

- **replace the annual test with a one-off test at the time the loan is entered into**, which massively simplifies administration and parallels the lending practices of financial institutions;
- **simplify the documentation requirements for non-related party debt**, to slash unnecessary compliance costs for loans that are clearly at arm's length; and
- **allow property groups to recognise credit support from related parties**, to align the tax treatment of property trust groups with consolidated corporate tax groups.

We have set out further details in the attached technical submission.

Please contact Belinda Ngo (on 0400 356 140) or me if you have any queries.

Yours sincerely,



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***Response to the
Board of Taxation's
Review of the
Thin Capitalisation
Arm's Length Debt Test***

*Property Council of Australia
March 2014*

Submission

On 16 December, 2013, the Board of Taxation (the Board) released a discussion paper canvassing various options to make the existing thin capitalisation Arm's Length Debt Test (ALDT) more effective.

The Property Council supports improvements to the ALDT that result in a test that reflects "real life" borrowing practices and reduces compliance costs.

However, industry does not support limiting taxpayer access to the ALDT.

Many property projects have a greater capacity for debt funding and appropriately rely on the ALDT.

Any restrictions on access to the test will increase the cost of providing these projects and make them more difficult to fund.

With the proposed reduction in the safe harbour debt amount from 1 July 2014, it is critical that the ALDT is not restricted to ensure that deserving commercial transactions are not blocked.

Accordingly, amendments to the ALDT should only focus on improving the commercial realism of the test and reducing compliance costs for taxpayers and the ATO.

The ALDT would benefit from changes that:

- reflect commercial borrowing considerations adopted by lenders, for example, by removing the need to test the borrowing annually outside of a 'material change' to the borrowing;
- limit 'material change' events to substantial changes to borrowings;
- allow for credit support from related parties within commercial / integrity boundaries; and,
- introduce additional safe harbour tests that do not limit access to the test or disturb the existing safe harbour debt amount.

1. Reduction of compliance costs for taxpayers

This part of our submission deals with the options canvassed in Chapter 4 of the Board's discussion paper.

1.1 Annual testing and material change

The current arm's length provisions require the ALDT to be undertaken annually.

This is an unnecessary compliance burden on the ATO and industry that is out of step with commercial practice and creates funding uncertainty.

Industry recommends changing the testing time of the ALDT to a test at inception that covers the term of the loan.

Additional testing should only be triggered if there is a 'material change' to the borrowing.

This approach parallels the lending practices of financial institutions and is consistent with the stated policy intent of the ALDT.

1.2 Material change

A 'material change', which would trigger re-testing of the ALDT, should only occur if there has been a substantial and permanent change to the borrowing.

The term should be defined to reflect events that would trigger a review by lenders in a commercial setting, e.g. a change in control or a material change in the assets of the borrower.

A material change should not arise where:

- there is a short term or immaterial change; or
- the loan agreement itself causes a change to the loan terms (e.g. the parties agreed to an interest rate step up at inception of the loan, and this is reflected in the loan agreement).

Different review triggers could be introduced for borrowings from associated and non-associated lenders.

For a non-associate lender, the 'material change' definition should be restricted to:

- where the lender becomes an associate of the borrower; and/or,
- a guarantee or other additional security is offered after commencement.

For an associate lender, additional review triggers could be added, such as a change in facility limits or interest rate changes and other such events that result in an actual substantial change to the borrowing.

1.3 Retrospective versus prospective focus of the ALDT

In assessing whether to lend to a borrower, financiers typically consider the future debt and interest coverage ratios of a borrower in addition to gearing levels.

In the property industry, gearing and anticipated gearing is most often the focus of a lender's assessment given that any loan will be secured against real assets as well as the underlying future cash flows.

Consistent with the goal of formulating an ALDT that parallels the lending practices of financial institutions, industry recommends that the ALDT have a forward looking focus rather than the current retrospective focus.

Amendments to the ALDT to change the testing time to a test at inception (and when other trigger events arise as discussed above) will assist in refocusing the test to have a prospective focus.

1.4 Additional safe harbour tests based on earnings

An optimal safe harbour test will:

- reflect a fair and reasonable metric that does not result in an uneven playing field for particular industries; and
- contain sufficient flexibility to allow the ratio to change with fluctuations in economic and other circumstances.

Industry supports alternate safe harbour tests provided that the new tests do not limit or remove access to the ALDT by taxpayers or impact upon the existing safe harbour test.

However, there are considerable difficulties in determining one ratio type (and ratio level) that can be applied across all taxpayers participating in different industries and even within different sectors of the property industry.

For example, capital intensive industries, such as the property sector, would be at a disadvantage compared with service industries if a blanket application of an EBITDA ratio was adopted.

Additionally, appropriate ratio levels will necessarily move over time due to economic factors and fluctuations in the debt markets (amongst other things).

1.5 Simplifying the ALDT where there is no related party debt

Industry supports simplifying the ALDT where there is no related party debt.

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 is raised on the capital markets and is only secured against Australian property.

1.6 Allowing credit support from related parties

Industry supports the proposal to allow credit support from related parties within accepted commercial / integrity boundaries.

At present, a taxpayer is unable to rely on credit support from a related party when applying the ALDT.

This feature of the ALDT unfairly disadvantages property industry participants who are unable to access the tax-consolidation regime.

For example, a corporate group that has consolidated for income tax purposes is treated as a single entity when, amongst other things, the ALDT is applied.

Any related party credit support provided by members of the tax-consolidated group to other group members (e.g. by the financier taking security over all of the group's assets) is not recognised for ALDT purposes on the basis of the single entity rule.

In contrast, it is common practice for investments in property to be done through unit trusts that are unable to consolidate for tax purposes.

Where a head unit trust borrows and the financier takes credit support over the entire group's assets, this gives rise to related party credit support for the purposes of applying the ALDT.

Property trust groups should be allowed to recognize the financial strength of other related party Australian entities similarly to what is now achieved by tax-consolidated corporate groups.

1.7 Advanced thin capitalisation agreements

Industry sees limited benefit from the proposed introduction of advanced thin capitalisation agreements.

It will be difficult to agree appropriate commercial parameters for such agreements that will provide taxpayers with the desired future certainty and within appropriate timeframes

Furthermore, the introduction of advanced thin capitalisation agreements will impose an even greater administrative burden on the ATO.

In the event that thin capitalisation agreements were introduced, participation should be voluntary and non-participation should not disadvantage taxpayers.

2. Easing the administrative burden for the ATO

This part of our submission deals with the options canvassed in Chapter 5 of the Board's discussion paper.

2.1 Reducing uncertainty

As borrowing levels in the property industry are generally dependent on underlying property values, the industry does not face the same level of uncertainty faced by other industries in determining the arm's length amount.

Industry would welcome guidance on the relevant factors that would be considered by the Commissioner when exercising the override power.

This guidance should be issued in the form of a Ruling or a Practice Statement, as it will be difficult to devise a list of legislative factors that would be equally relevant to all taxpayers.

The proposed change from an annual test to a "once-off" test (as discussed above) will also remove the uncertainty currently caused by the requirement to test the various factors "throughout the income year".

2.2 Documentation time limits

Industry would support a move towards having no time limits on the ALDT documentation requirements.

This is consistent with the transfer pricing rules where there is no time limit for documentation, however, taxpayers who do maintain contemporaneous documentation enjoy protection from penalties.

3. Eligibility for the arm's length debt test

This part of our submission deals with the options canvassed in Chapter 6 of the Board's discussion paper.

3.1 Limiting access to ALDT

Industry does not support limiting the eligibility of taxpayers to access the ALDT.

Limiting access to the test may inadvertently discriminate against taxpayers with projects which have a greater capacity for debt funding.

Any restrictions on access to the test will increase the cost of providing these projects and make them more difficult to fund.

With the proposed reduction in the safe harbour debt amount from 1 July 2014, it is critical that the ALDT is not further fettered to ensure that deserving commercial transactions are not blocked.

Devising an exclusion test without sufficient flexibility will produce inequitable outcomes and prevent the funding of important projects.

3.2 Mandatory advance ruling system

Industry does not support the introduction of a mandatory advance ruling system to access the ALDT.

Forcing all taxpayers to apply for an ATO ruling before they enter into any debt funding arrangement will impede investment decisions, block critical projects and unnecessarily increase compliance costs for business and the ATO.