



The Board of Taxation
c/The Treasury
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14 March 2014

Dear Madam/Sir

Review of the Thin Capitalisation Arm's Length Debt Test

PricewaterhouseCoopers ("PwC") thanks the Board of Taxation ("The Board") for the opportunity to make this submission in response to The Board's Discussion Paper ("Discussion Paper") issued on 16 December 2013.

In the Discussion Paper, The Board is seeking views from stakeholders on the following issues:

1. How to reduce compliance costs for Australian taxpayers and make the arm's length debt test ("ALDT") easier to comply with;
2. How to make the ALDT easier for the Australian Taxation Office ("ATO") to administer; and
3. Who should be eligible to access the ALDT and in what circumstances.

PwC welcomes and supports action to make the ALDT easier to comply with and administer. We will address each of the above areas in turn below. At the outset we note that we have not attempted to address each of issues/questions raised by The Board in the Discussion Paper but provide our general comments on particular aspects of each of the above areas. Our comments draw on PwC's experience with applying the ALDT for numerous taxpayers.

Executive Summary

In essence, the purpose of the thin capitalisation legislation is to ensure integrity and fairness of the Australian taxation system by preventing multinational entities from allocating an "excessive" amount of debt to their Australian operations.¹ The guiding principle underlying the thin capitalisation rules is the arm's length standard, drawing on the arm's length principle adopted by the Organisation for Economic Cooperation and Development (OECD) and consistent with Australia's DTAs.² The safe

¹ New Business Tax Systems (Thin Capitalisation) Bill 2001, Second Reading Speech.

² OECD Model Tax Convention on Income and on Capital.



harbour test exists to provide simplicity and certainty to taxpayers. The ALDT was introduced as part of the thin capitalisation legislation for taxpayers that may fail the safe harbour test but for whom gearing levels could otherwise be commercially justified or acceptable. Therefore, the ALDT is founded on a legitimate policy basis in recognition that some gearing levels may be commercially viable notwithstanding that they exceed the prescribed safe harbour limit.

The option to limit access to the ALDT to a select group of taxpayers or industries would appear to have no clear policy basis, would be contrary to the intent of thin capitalisation rules, and would go against the stated objective of making the ALDT easier to administer as such restrictions risk being arbitrary or inadequately defined.

Against this background, PwC does not support an entry rule to access the ALDT but submits that the ALDT should be retained for all taxpayers.

Given the continuing policy basis for an ALDT to be accessible by all taxpayers, focus should be on the simplification of the ALDT and the documentation process that would allow for a decrease in compliance costs.

The changes should minimise the compliance and administration burden and balance the competing objectives of revenue protection and allowing taxpayers greater freedom to choose their own funding structure.

Further, we believe the general requirement to prepare documentation should be balanced with the level of risk involved and the compliance burden on the taxpayer. To this end, rather than requiring the ALDT to be documented at the time of lodging a tax return, we would favour a more flexible ‘risk based approach’ to allow taxpayers to apply “principles of prudent business management” when determining the extent of documentation they may require to demonstrate compliance with the ALDT. This would ensure that the documentation takes into account the size of the loan transactions and the tax risks associated with the transactions.

The Discussion Paper canvasses a number of possible ways in which to make the ALDT easier to comply with and administer. We summarise some of the key issues and PwC’s recommendations to The Board in the table below.

No.	Issue	Recommendation
1.	Simplify the ALDT when there is no related party debt	We recommend that taxpayers who are funded with third party debt and have no explicit affiliate guarantees should be exempt from the need to prepare documentation.
2.	Exemption for certain special purposes entities	We recommend further legislative or administrative guidance clarifying the carve-out from the thin capitalisation rules for securitisation, project finance and other vehicles which are predominantly funded by third party debt.

No.	Issue	Recommendation
3.	Identification and exclusion of credit support	We recommend further legislative or administrative guidance clarifying that the requirement to exclude guarantees and other forms of credit support does not extend to <i>implicit</i> credit support provided by a parent or group.
4.	Independent lender and borrower tests	We recommend that the independent borrower test be retained and do <u>not</u> advocate moving solely to an 'independent lender' test.
5.	Additional safe harbour tests	<p>We support the introduction of an additional safe harbour test based on earnings, such as earnings before interest, tax, depreciation and amortisation (EBITDA), as an alternative to the existing debt-to-asset ratio, but only as an optional fall-back at the taxpayer's option on a year-by-year basis and not as a replacement to the existing test.</p> <p>As an alternative to the current asset-based test, we recommend consideration be given to using as the test the debt-to-asset ratio of the global/worldwide group.</p> <p>In addition, we recommend that the non-deductible portion of interest expense under the safe harbour test be allowed to be carried forward indefinitely.</p>
6.	The need for annual testing	We recommend legislative clarity that taxpayers can rely on the ALDT analysis prepared for an earlier year if there have been no 'material adverse changes' in the relevant income year.
7.	Retrospective versus prospective focus	There should be flexibility to apply the ALDT using forecasted financial data.
8.	Determination of the notional amount of debt 'throughout the income year'	We recommend legislative clarity that taxpayers can use measurement days under Subdivision 820-G for purposes of calculating the notional arm's length debt amount that the taxpayer would reasonably be expected to have 'throughout the year'.
9.	Nature of 'commercial lending institution'	We recommend legislative clarity that the definition of 'commercial lending institution' is not confined to a narrow interpretation and that it extends to all debt markets and all types of lenders.

No.	Issue	Recommendation
10.	Documentation	We recommend a more flexible 'risk based approach' to allow taxpayers to apply "principles of prudent business management" when determining the extent of documentation they may require to demonstrate compliance with the ALDT.
11.	Eligibility criteria	We do not support an entry rule to access the ALDT but submit that the option of using the ALDT should be retained for all taxpayers.
12.	Advanced thin capitalisation agreements	We agree in principle that an advance ruling or determination system would provide certainty to taxpayers; however, we submit that this could be achieved through existing private ruling / APA system and should not be a mandatory requirement.
13.	Interaction with PE attribution rules	We recommend legislative or administrative clarity on how the ALDT interacts with the approach to the attribution of interest to PEs under Australia's PE attribution rules.

1. Options to reduce compliance costs for taxpayers

Simplify the ALDT when there is no related party debt

The ALDT provides a framework for determining an entities arm's length debt amount where:

- a. The debt is provided by a related party on terms that cannot be easily demonstrated to be arm's length;
- b. The debt is provided by non-associates but with credit support from associates of the taxpayer; and/or
- c. The taxpayer has businesses other than its Australian business which supports its actual debt levels.

In each of the above scenarios it is necessary to hypothecate the arm's length amount of debt on a different basis from the circumstances that surround the debt actually issued. It is in these types of circumstances for which the ALDT is primarily designed. The ALDT as it currently operates imposes an unnecessary burden on taxpayers for which the above circumstances are not present. In particular, the current rules appear excessive as they apply to taxpayers with no related party debt and no explicit credit support from associates should be simplified for those circumstances on the basis that by definition the arm's length test is satisfied.



We recommend that taxpayers that are funded entirely with third party debt and have no explicit credit support from associates should be exempt from the need to prepare documentation in support of application of the ALDT.

Exemption for certain special purposes entities

Of particular concern is the current uncertainty as to how the thin capitalisation rules apply to securitisation, project finance and other vehicles established for infrastructure projects and which are predominantly funded by third party debt.

The section 820-39 exemption provides an exemption from the thin capitalisation rules for certain special purpose entities where all of the following conditions are satisfied;

- (a) the entity is one established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself);
- (b) the total value of debt interests in the entity is at least 50% of the total value of the entity's assets; and
- (c) the entity is an insolvency-remote special purpose entity according to criteria of an internationally recognised ratings agency that are applicable to the entity's circumstances.

In recent discussions with the ATO, it has become clear that some sections of the ATO were initially of the view that the section 820-39 thin capitalisation exemption should only apply to "traditional" securitisation vehicles e.g. residential mortgage back securities.

There is nothing in the legislation to suggest that the section 820-39 exemption was to provide a thin capitalisation exemption in such limited circumstances. It has been widely understood that the finance vehicles employed in infrastructure projects should qualify for the section 820-39 exemption. Indeed, the ATO has recently issued a draft Taxation Determination (TD 2014/D8) confirming that the section 820-39 exemption applies in those circumstances (which is a welcome step forward).

Given the focus on the Government on the importance of infrastructure investment in boosting national productivity and providing social services, we recommend that the application of the section 820-39 exemption to project finance vehicles used in infrastructure projects is explicitly legislated in a way that is broad enough to cover infrastructure projects more generally and flexible enough to deal with changes to ratings agency criteria. This would help to reduce the current uncertainty (even following the release of TD 2014/D8) surrounding the application of the exemption to infrastructure projects. **Further legislative or administrative guidance clarifying the exemption from the thin capitalisation rules for securitisation vehicles is recommended.**

Identification and exclusion of credit support

In determining the arm's length debt amount, the law requires certain factual assumptions to be taken into account which have the effect of replacing the actual conditions that took place



throughout the year. In essence, the purpose of the factual assumptions is to ensure that only the Australian business of the taxpayer is taken into account in determining its debt capacity and that the terms and conditions of the debt are arm's length by disregarding any credit support from associates.

There is scope for reducing compliance costs by aligning the factual assumptions with the transfer pricing rules insofar as possible, recognising that there is an overlap between the ALDT and transfer pricing rules.

One area where the ALDT interacts with the transfer pricing rules is in the treatment of credit support. The factual assumptions require the arm's length debt analysis to be conducted on the basis that any credit support provided by associates is ignored.

We submit that the requirement to exclude guarantees and other forms of credit support should not extend to *implicit* credit support provided by a parent or group.

Such a treatment would be consistent with general treatment of implicit credit support under the transfer pricing rules which is a relevant factor in assessing the credit profile of the borrower for purposes of determining arm's length interest rates. This also reflects commercial lending practices and the approach adopted by ratings agencies when assigning credit ratings to companies that are tied together by a parent and subsidiary relationship.

Legislative or administrative clarity in this regard would be welcome.

Furthermore, where an Australian taxpayer has received explicit credit support from associates, the ALDT could be simplified by introducing a threshold limit on the need to undertake further analysis to exclude such credit support for the purposes of determining the arm's length debt amount, e.g. if the average assets of the Australian entity comprise 90% or more of the average total assets of the Australian business and relevant associates.

Independent lender and borrower tests

PwC welcomes the consideration of options to reduce the compliance and administrative burden; however, we caution that this outcome must not be sought at the expense of maintaining the integrity of the ALDT.

We consider that the 'independent borrower' test is an important integrity provision by requiring that the analysis focus not on just what the business *could* have borrowed, but what it *would* have realistically borrowed such that it results in an adequate return to shareholders after the obligations to debt holders have been satisfied.

We acknowledge that the application of the independent borrower test does suffer from some practical limitations such as sensitivity to recognition and/or valuation of assets and equity capital; however, we note that these are common to any transfer pricing analysis involving the application of profit based methods.



Overall, we feel that the independent borrower 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.

As noted elsewhere in this submission, the application of the independent borrower test can be simplified by allowing taxpayers to rely on an analysis prepared for an earlier year if there have been no material adverse changes in the relevant income year (see comments below under the need for annual testing). Further, there should be flexibility to apply the independent borrower test using forecasted financial data in recognition that an investor would typically have regard to the forecasted rates of return.

We therefore do not believe there is a reasonable basis on which to argue for the removal of the independent borrower test and moving to a solely independent lender test. However, the application of the independent borrower test should be simplified by removing the requirement for annual testing where there are no material adverse changes in the relevant income year.

Additional safe harbour tests

An asset-based approach under the current safe harbour rules favours asset-based industries such as the infrastructure and property industries and discriminates against non-asset intensive industries such as services industries, with significant amounts of internally generated goodwill or intangibles not recognised on their balance sheets but strong cash flows. As such, an EBITDA test is likely to be more appropriate for these types of entities.

PwC supports the proposal set out in paragraphs 4.14 to 4.19 to introduce an additional safe harbour test based on earnings as an alternative to the existing debt-to-asset ratio, but only as an optional fall-back at the taxpayer's option on a year-by-year basis and not as a replacement to the existing asset-based test which caters to asset-based industries such as the infrastructure and property industries.

This would address the concerns expressed by stakeholders with an EBITDA test in response to the Business Tax Working Group's discussion paper. It would also serve to reduce the need for some taxpayers to rely on the ALDT, thereby easing the compliance and administrative burden and more appropriately catering for the expanding services sector of the Australian economy.

Clearly, it will be important to set the EBITDA percentage at an appropriate level. This should have regard to international practice where an EBITDA-based test has been adopted.

Another limitation of the existing asset-based test is that it does not reflect the gearing of individual industry subsectors.

As an alternative to the current asset-based test, the Government could consider using as the test the capital structure of the global/worldwide group such that the interest expense is fully deductible if the taxpayer has a debt-to-asset ratio equal to or lower than the global debt-to-asset ratio based on the worldwide consolidated balance sheet.



This has the advantage of providing an ‘internal comparable’ that more accurately reflects an arm’s length funding structure for the taxpayer’s industry particularly for taxpayers in traditionally highly geared industries who would otherwise have to rely on the ALDT.

In addition, we propose that the non-deductible portion of the interest expense under the safe harbour test be allowed to be carried forward indefinitely.

Currently, interest denied under safe harbour rule is permanently denied, which puts pressure on the ALDT as a fall-back. The allowance of an indefinite carry-forward period will provide less of an incentive to rely on the ALDT, thereby reducing the compliance and administrative burden. We note this approach is consistent the thin capitalisation regimes in other jurisdictions such as Germany.

The need for annual testing

The legislation currently requires that the determination of an arm’s length debt amount be done annually.

This does not reflect commercial lending practices. A commercial lender acting at arm's length will provide finance based on their view of current and reasonably foreseeable conditions at the time they make the decision to provide the finance. To the extent that there are uncertainties around future events, the lender would typically be aware of the possibility of these and by entering into the transaction, accept that these uncertainties may materialise. To the extent possible the lender will seek to implement covenants to protect itself from possible deterioration of the borrower, such that the loan principal and or interest may be at risk.

Under typical commercial lending practices, a bank has a contractual commitment to lend provided that the borrower is in compliance with the facility’s conditions for funding, or financial covenants (e.g. a fixed charge coverage test). Violation of certain of the covenants typically relieve the bank from an obligation to continue to advance funds.

Similarly, where a company enters into a line of credit or revolving loan facility that allows the company to draw down, repay and re-draw over a number of years, then it should be sufficient to test the arm’s length debt amount at the time of the loan without the need for annual re-testing. This is on the basis that the lender has agreed the maximum amount that can be loaned at the outset and would have covenants in place to ensure the borrower can continue to service the loan over the term of the facility.

We recommend that as is the case in existing transfer pricing rulings, allowance be made for taxpayers to rely on analysis prepared for an earlier year if there have been no ‘material adverse changes’ (MAC) in the relevant income year.

For this purpose, MAC might be defined as changes in the financial performance of the borrower that would result in a breach of financial covenants or MAC 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.



We note that this is consistent with the intended application of the thin capitalisation rules as supported by the Explanatory Memorandum at paragraphs 10.55 to 10.57 and by the Commissioner in TR 2003/1 which allow the factors that existed at the time that debt capital was last raised, to be considered.

The EM at paragraphs 10.55 and 10.56 states:

‘The analysis of the relevant factors in the year the entity last raised debt capital may be the most important analysis in some circumstances. Specifically, where the entity has not raised debt capital in the intervening time and the relevant factor analysis for the year in which debt was last raised and the current year would be similar, the entity may rely on that earlier analysis.’

‘The purpose of adopting this factor is to eliminate the compliance burden of doing a comprehensive arm’s length analysis every year when it is clear that nothing has materially changed.’

Accordingly, we submit 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. However, legislative clarity would be welcome.

Retrospective versus prospective focus

In determining whether and how much funds to extend to a borrower, a commercial lender typically considers the current and future cash flows and earnings which will be used to service and ultimately repay the debt, particularly for start-ups and taxpayers involved in certain public-private partnership (PPP), infrastructure and property projects where long-term cash flows (such as revenue streams) are already locked in and are by nature a critical consideration for lenders.

It is not uncommon, especially during the early stages in an infrastructure project, for an entity to have relatively high debt levels due to the significant initial outlay. This however may not concern commercial lenders as they account for other factors such as the long term nature of infrastructure projects and the strength and certainty of future revenues.

Likewise, an investor would have regard to the forecasted internal rates of return (IRR) in determining an appropriate level of gearing. By leveraging at an interest rate less than the IRR, the post interest returns would be higher with the inclusion of the debt than without.

On this basis, there should be flexibility to apply the ALDT using forecasted financial data.

Documentation

Section 820-980 requires that taxpayers maintain records for an arm’s length debt amount that the entity has worked out for the purposes of Division 820. These records must contain particulars about the factual assumptions and relevant factors in section 820-215.



We appreciate the general requirement for taxpayers to prepare documentation to support the application of the ALDT. We believe this requirement should be balanced with the level of risk involved and the compliance burden on the taxpayer.

In our view, the annual requirement to prepare documentation in the form currently specified in TR 2003/1 is onerous and does not provide this balance. In particular, the requirement to document the application of the ALDT regardless of materiality or potential risk creates an excessive compliance burden for taxpayers with relatively small levels of debt. As such, rather than requiring the ALDT to be documented at the time of lodging a tax return, **we would favour a more flexible ‘risk based approach’ to allow taxpayers to apply “principles of prudent business management” when determining the extent of documentation they may require to demonstrate compliance with the ALDT.** This is supported by the OECD and also by the Commissioner in existing rulings regarding preparation of documentation (TR 98/11). This would ensure that the documentation takes into account the size of the loan transactions and the tax risks associated with the transactions.

We also recommend that as in existing transfer pricing rulings, allowance be made for taxpayers to rely on documentation prepared for an earlier year if there have been no material adverse changes in the relevant income year (see comments above).

2. Easing the administrative burden for the ATO

Use of the ALDT

A key criterion in evaluating the need for measures to make the ALDT easier for the ATO to administer is the extent to which taxpayers currently rely and are expected to rely on the ALDT following the change in the safe harbour limits.

There is a concern, as cited in the Discussion Paper, that tightening of the safe harbour limits may lead to a significant increase in the number of taxpayers using the ALDT. It is open to question whether this concern is valid. In this regard, it is cited at paragraphs 3.31 to 3.36 of the Discussion Paper that:

- only 55 taxpayers relied on the ALDT in 2011 compared with 480 taxpayers with disallowed debt deductions under the safe harbour or worldwide gearing test (i.e. approximately 10% take up);
- the ATO estimates that up to 330 entities would have deductions denied under the rules, i.e. fewer than the 480 under the old rules; and
- the majority of the excess deductions relied upon under the ALDT were by taxpayers in the utilities and construction sectors who would be expected to continue to use the ALDT in any event.

While we appreciate the difficulty in estimating the extent to which the change in the safe harbour rules will affect the use of the ALDT, **we believe that if measures are taken to reduce compliance costs as set out above, especially the exemption where there is no related party debt or credit support, then the tightening of the safe harbour limits**



will not necessarily lead to a significant increase in the use of the ALDT. This cautions against precipitate change to existing arrangements.

In any case, while we acknowledge that the ALDT creates an administrative burden for the ATO, this should be no greater than the burden that currently exists in respect of the application of the new transfer pricing rules under subsections 815-B to 815-D of the ITAA 1997 which require an analysis of the arm's length conditions of related party loans. We consider that the administration of the ALDT can be addressed within the existing administrative procedures for dealing with transfer pricing, for example, the thin capitalisation provisions under Division 820 of the ITAA 1997.

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

We support the use of measurement days under Subdivision 820-G for purposes of calculating the notional arm's length debt amount that the taxpayer would reasonably be expected to have 'throughout the year', as this enables a proper comparison with the Adjusted Average Debt which is calculated using this method. Legislative clarity would be welcome to ensure that both taxpayers and the ATO have clarity in application.

Qualities of the commercial lender

The term "commercial lending institution" is not defined in the thin capitalisation rules. The ATO in TR 2003/1 takes a broad interpretation of the term, indicating that it is not confined simply to banks but extends to the raising of debt capital on any market (citing the bond market as an example).³

We agree that the term should be given a wide meaning and submit that it should extend to all debt markets (both liquid and illiquid) and all types of lenders who would be prepared to lend to the company at arm's length, taking into account the borrower's ability to service the debt, the risk of default, assets as security, etc.

For example, private equity buyouts and property deals often involve financing from unconnected senior lenders as well as mezzanine lenders which can be accepted as being at arm's length. This is also acknowledged by HM Revenue & Customs (HMRC) in its guidance on thin capitalisation.⁴

Legislative clarity would be welcome.

3. Eligibility for the ALDT

Eligibility criteria

We observe that the ALDT is founded on a legitimate policy basis. This is stated in the EM which accompanied the introduction of the test:

³ TR 2003/1 Income tax: thin capitalisation – applying the arm's length debt test, paragraph 28.

⁴ INTM580070 - Thin Capitalisation: private equity: Working the case: third-party loan agreements.

“2.6 The prescribed safe harbour debt to equity ratio may be exceeded in circumstances where the funding structure could be maintained on an arm’s length basis. In such a situation, no deductions will be disallowed. This change recognises that some funding arrangements may be commercially viable notwithstanding that they exceed the prescribed limits. It also makes the rules more consistent with Australia’s DTAs.”⁵

There does not appear to be a clear policy basis for limiting access to the ALDT, other than as a revenue saving measure. This is contrary to the intent of thin capitalisation rules. In PwC’s view, major changes in the application of tax laws should not be without a clear policy basis.

It is our view that the ALDT is a necessary alternative to the safe harbour gearing levels. This is because the arm’s length level of gearing differs significantly between industries and entities of various sizes, and the application of a generic safe harbour gearing level can result in arbitrary outcomes. We are concerned that imposing eligibility criteria will unfairly discriminate against taxpayers which have a greater capacity for debt funding (see comments under ‘Additional safe harbour tests’).

An additional concern and complication arises from the fact that it is unclear what precisely the definition of who is eligible would be. Where do you draw the line? Limiting access to ALDT according to the nature of taxpayer activity or industry would be unduly prohibitive and as noted in paragraph 6.4 of the Board’s Discussion Paper, the nature of entities that used the ALDT in the past may not be reflective of entities that use it in the future (and having regard to Australia’s economy and ever-changing growth sectors). A legislative framework to limit and define eligibility would potentially create an additional compliance burden in interpreting entitlement to access. There will be difficulties in interpretation at the edges e.g. how do you define what is an infrastructure related business? As such restrictions risk being arbitrary or inadequately defined, the uncertainty of which would go against the policy objective of making the ALDT easier to administer.

Of particular concern is that the option of limiting access to the ALDT canvassed in the Discussion Paper may serve to make investment in infrastructure projects less attractive for investors. Debt financing is a key feature of infrastructure investment in Australia, and many entities investing in infrastructure are therefore subject to the thin capitalisation rules.

Many infrastructure projects have debt to equity ratios which significantly exceed the current safe harbour ratio of 3:1 and as such have had to rely on the ALDT. These entities are able to support a level of debt in excess of the safe harbour amount as investment in such infrastructure assets typically offers long term, secure, low volatility and inflation-linked income streams that are payable by creditworthy government bodies.

The tax deductibility of the interest on this debt is one important factor in investors’ cash flows and achieving an appropriate rate of return for their equity. By potentially limiting the tax deductibility of the interest on this debt, and thereby reducing the rate of return, any measures to limit access to the ALDT could serve to deter investment in infrastructure projects by affecting the economics of existing as well as future projects, thereby undermining the Government’s core economic and social objectives. Limiting access to the ALDT will also serve to increase “sovereign

⁵ New Business Tax System (Thin Capitalisation) Bill 2001



risk” associated with Australia as was seen with the increase in the Managed Investment Trust withholding tax rate from 7.5% to 15% by the previous Labor Government.

We submit that any measures that would potentially create a disincentive for infrastructure investment or impede Australian competitiveness in attracting foreign investment in general should not be pursued.

Notwithstanding all the above, to the extent that measures are taken to reduce compliance and administrative costs as set out in this submission, then the case for limiting access to the ALDT would be less pronounced.

Therefore, PwC does not support an entry rule to access the ALDT but submits that the ALDT should be retained for all taxpayers.

Advanced thin capitalisation agreements

We agree in principle that an advance ruling or determination system would provide certainty to taxpayers; however, this could be achieved through the existing private ruling / APA system used at the taxpayer’s option and it should not be a mandatory requirement to access the ALDT. We believe that involving ATO officers who have practical knowledge and experience of lending practices would help to improve the efficiency of the process.

The ATO has systems in place to have line of sight over the extent to which taxpayers may use the ALDT (currently and in the future) through disclosures on the International Dealings Schedule, or pre-lodgement compliance reviews.

4. Other considerations

Interaction with permanent establishment attribution rules

The thin capitalisation rules affect foreign entities with Australian permanent establishments (PEs) as well as Australian entities with foreign PEs.

Under Australia’s PE attribution rules, the interest expense incurred on funds borrowed by an entity that are used in connection with the business carried on through its PE, is attributable to the PE.

In determining the amount of an entity’s interest expense that is attributable to its PE, two alternative approaches are commonly adopted⁶:

1. the “tracing approach”, which seeks to trace the funds used by a PE to actual borrowings from third parties; or

⁶ See TR 2001/11 Income tax: international transfer pricing – operation of Australia’s permanent establishment attribution rules, paragraph 3.44.



2. the “fungibility approach”, under which the entity’s pool of borrowed funds and associated interest expense are allocated amongst its parts using an appropriate “key” such as gross revenues or assets.

There is a risk that the ALDT as it applies to foreign entities that carry on business through Australian branches and Australian entities that carry on business at or through overseas branches may be interpreted in a way that is inconsistent or in conflict with the approach to the attribution of interest to PEs under Australia’s PE attribution rules. Such a conflict could lead to increased confusion and uncertainty in what is already a highly uncertain and complex area of law.

Legislative or administrative clarity would be welcome.

* * * * *

We commend the Government for undertaking this review and seeking to address some of the difficulties faced by taxpayers and the ATO in complying with and administering the ALDT in practice.

We would be pleased to discuss any aspect of our submission with you further.

Yours sincerely

A blue ink signature of Nick Houseman, consisting of a stylized 'NH' followed by a long horizontal flourish.

Nick Houseman
Partner
Transfer Pricing

A blue ink signature of George Condoleon, consisting of a stylized 'GC' followed by a long horizontal flourish.

George Condoleon
Director
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