

Australia: Discussion Paper released on the arm's length debt test

December 19, 2013

In brief

The Board of Taxation (BoT) released a Discussion Paper on 16 December 2013 as part of its mandate to provide a report on the operation of the arm's length debt test (ALDT) contained in Australia's thin capitalisation regime. In particular, the BoT has outlined in its Discussion Paper a number of suggestions to make the ALDT easier to comply with from both the perspective of taxpayers and the Australian Taxation Office (ATO). BoT has also considered eligibility criteria for the ALDT. A range of questions have been outlined in the Discussion Paper and stakeholders have been requested to provide responses by 14 March 2014, with the BoT due to issue its final report to the Government in December 2014.

In detail

Background to the review

The ALDT is an alternative approach provided to taxpayers in the thin capitalisation regime to support a level of debt which is considered 'commercial or independent'. The review of the ALDT was announced as part of the 2013-2014 Federal Budget and at the same time as changes to Australia's thin capitalisation rules were announced proposing reductions to the safe harbour limits.

BoT was requested to undertake a review of the ALDT with a view to make it easier to comply with and to clarify in what circumstances the test should apply.

In the period since the review was announced the BoT has

conducted targeted preliminary consultations to understand the different perspectives of stakeholders on the issues within the scope of the review.

The Discussion Paper outlines some background to the ALDT and its policy intent before requesting feedback around the following three areas subject to the review:

1. Reduction of compliance costs for taxpayers.
2. Easing the administrative burden for the ATO.
3. Eligibility for the ALDT.

Reduction of compliance costs for taxpayers

A number of areas have been raised where compliance costs for taxpayers could be reduced. These include:

- Whether there is a need for annual testing in all cases, i.e. should the test only apply in the year in which the borrowing takes place?
- Whether the test should be focused on prospective conditions rather than on current or past conditions, particularly in the case of start-ups or changes in economic conditions.
- Whether there should be additional safe harbour tests based on earnings (for example, an EBITDA test).
- Whether the test should be simplified in circumstances where there is no related party debt, i.e. where debt is lent from a third party such as a bank.

- Whether the test should permit recognition of the financial strength of other related Australian entities; particularly in the case of property groups that operate through stapled structures or a holding structure with subsidiary trusts where a third party financier takes security over all of the assets of the group.
- Whether there should be a process for entering into advance thin capitalisation agreements with the ATO, similar to the UK.

In addition, a number of issues were raised by the ATO and the BoT is seeking submissions on whether addressing these issues would assist in reducing uncertainty and compliance for taxpayers. Issues identified include:

- Practical challenges complying with the independent lender and independent borrower test.
- Practical difficulties in making a distinction between the amount that an entity 'would' reasonably be expected to borrow and the amount the entity 'could' reasonably be expected to borrow.
- Ability to rely on internally generated goodwill.
- Difficulties in identifying the relevant Australian business; particularly where there are significant offshore activities and where financial data on certain foreign subsidiaries may not be subject to the same level of accurate application of accounting standards or independent audit scrutiny.

- Identification and exclusion of guarantees, security or other forms of credit support, i.e. parent or group affiliation, implicit/explicit parent support, etc.
- Use of benchmarking analysis to confirm arm's length debt and difficulties in the approach where the amount of debt includes hybrid instruments that may be treated differently from an accounting perspective.

Easing the administrative burden for the ATO

Consistent with the terms of reference, the Discussion Paper also addresses the ways to make the ALDT easier for the ATO to administer. Some of the issues raised in this context include:

- Uncertainty over the Commissioner's override power and how this might be used; particularly in the context of the difficulties in identifying a single definitive arm's length amount of debt given that a subjective assessment based on judgement is required.
- Dealing with uncertainty over an entity's capacity to meet all its liabilities over a long period of time, despite the ALDT being a year-by-year test.
- Difficulties in dealing with the differences of views on the degree of relevance that should be placed on the factors required to be taken into account; in particular consideration of profitability, return on capital and debt to equity.
- Dealing with the impact of changing economic conditions

within a year that may have an impact on the amount of notional debt capital that would be held and provided throughout the year.

- Dealing with the difficulties presented by the fact that different commercial lenders may have different risk appetites in terms of the amount of debt that they would be prepared to lend.

Some of the options raised through the consultation process for reducing compliance costs include:

- Providing flexibility in the timing of when documentation is required to be prepared.
- Harmonisation of the transfer pricing legislation and the ALDT.

Eligibility for the ALDT

The Discussion Paper raises the question of whether the ALDT should be in some way restricted in its application and, if so, how the eligibility criteria should be defined. There is recognition that the ALDT by its nature imposes greater compliance costs for taxpayers and administration costs for the ATO. In preliminary consultations the BoT has sought to identify whether there should be an entry rule to access the ALDT and the particular circumstances that would justify that access.

It is noted that the ALDT is of particular importance to taxpayers in certain sectors and industries. In particular, large scale capital intensive industries, infrastructure projects and the property sector all have significant funding requirements and can typically have leverage ratios in excess of the safe harbour limits. However it is also recognised that there could be practical difficulties in defining eligibility to the test by defining parameters or specific industries.

Accordingly, the BoT seeks comments on who should be eligible to access the arm's length test and in what circumstances (i.e. whether restrictions/limitations should apply or even whether the ALDT should be restricted by an advance ruling or determination from an established body or specially designated independent expert panel.

The takeaway

The Discussion Paper is an opportunity for interested taxpayers to contribute to the review and provide input to the Board's review. It is important to note that any proposed changes to the safe harbour limits are proposed to have effect from 1 July 2014, some six months before the BoT is due to deliver its report to

Government. Accordingly, the issue will be important not just for taxpayers that currently rely on the ALDT, but for those that may have a need to rely on the test in the future.

The BoT is seeking submissions addressing the terms of reference and the issues/questions in the Discussion Paper to assist with the review by 14 March 2014.

Let's talk

For more information, please contact:

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