INFRASTRUCTURE
PARTNERSHIPS
AUSTRALIA

27 August 2019

Cindy Perryman
Public Groups and International
Australian Taxation Office
GPO Box 9990
SYDNEY NSW 2001

Sent via email to: PGIFinancing@ato.gov.au

Dear Ms Perryman,

Re: Thin Capitalisation: The Arm's Length Debt Test Draft Taxation Ruling (TR 2019/D2)

Infrastructure Partnerships Australia welcomes the opportunity to provide the following comments on the Draft Taxation Ruling (TR 2019/D2) which sets out the Australian Taxation Office's (ATO) preliminary views on the application of the Arm's Length Debt Test (ALDT) contained within the thin capitalisation rules.

High Level Comments

Broadly, Australia's Thin Capitalisation Rules deny debt deductions to the extent an entity's debt levels exceed certain gearing levels for financing permitted by the Thin Capitalisation Rules. The ALDT is one of three methods utilised to work out the permissible gearing level for inbound or outbound financing of an entity.

While we welcome the ATO draft interpretative guidance on key technical issues, firstly we highlight that the ALDT requires a weighting of factors based on the required statutory assumptions and thus the analysis will very much depend on the particular facts and circumstances of each case.

Secondly, we note the overlap between Australia's Transfer Pricing Laws and Thin Capitalisation Rules and specifically that each of sub-division 815-A, B and C deals with the interaction of the Thin Capitalisation and Transfer Pricing Laws as they apply to debt deductions. Most importantly, for example sub-division 815-B contains a special rule in Section 815-140 which modifies the way an entity works out its taxable income or loss. Essentially, taxpayers are directed to apply sub-division 815B prior to applying the Thin Capitalisation Rules in determining the appropriate, amongst other things, debt deductions available.

Detailed Comments

1. Paragraph 34-37 – Would Borrow vs Could Borrow:

Current thin capitalisation rules see debt deductions for taxpaying entities reduced to a point where their adjusted average debt exceeds their maximum allowable debt. Maximum allowable debt is calculated as the greater out of three amounts:

- The Safe Harbour Debt Amount
- The Worldwide Gearing Debt Amount
- The Arm's Length Debt Amount (ALDA).

The Draft Ruling sets out two elements of the ALDT which are used to determine the ALDA.

- The independent borrower test (the amount the borrower would reasonably expect to have borrowed), and
- The independent lender test (the amount a commercial lending institution would reasonably expect to have loaned.

An issue arising from the application the ALDT is that it may over-emphasise the amount of debt a taxpaying entity could borrow, even though the amount an entity may be willing to borrow may be less than the amount lending institutions are willing to lend.

Paragraph 35 states that the amount should be what one "would" vs "could" borrow. This discussion continues on through paragraphs 36 and 37. This has raised concerns for some investors in that although a taxpaying entity could borrow a higher level of debt (which would be considered arm's length), if it is not what most entities would do, it appears this debt would be denied. Since different entities have different risk profiles (particularly on debt assumptions) and different return requirements, enforcing such a test appears difficult to implement and potentially problematic.

2. Paragraphs 38-41 – The ALDT is an Annual Test:

Under the legislation the ALDT must be determined on an annual basis. According to paragraph 41, this means that a taxpaying entity could fail to meet the ALDT in certain years where it is relied upon, but be supported by the ALDT in other years.

We submit that this may raise issues for the application of the ALDT, because although the test is required to be done annually, if market conditions worsen (and raising such debt in that market would be unlikely, it may therefore not be arm's length). However, the taxpaying entity would still have an obligation to pay the existing debt. It would seem unreasonable for the debt to be disallowed under this scenario.

3. Paragraphs 70–73, 95 – Implicit and Explicit Credit Support:

The Draft Ruling requires a taxpaying entity to borrow on a standalone basis, without any form of credit support, whether it be explicit support such as financial guarantees or implicit support such as letters of comfort.

We submit that the ATO should where possible provide practical guidance on implicit and explicit credit support given it is an important feature for many borrowers. Specifically, it is highly relevant in project finance models where guarantees and security arrangements are common.

Weighting of Factors

As indicated earlier, ultimately the application of the ALDT requires a weighting of factors in determining the permissible gearing level for both inbound and outbound entities and investment, based on the statutory assumptions. This weighting of factors will very much depend on the individual facts and

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circumstances of each case - including in the context of Bank lending criteria and the approaches of credit rating agencies.

Conclusion

With reference to the issues described above, Infrastructure Partnerships Australia looks forward to further clarification being provided in the ATO's forthcoming practical compliance guidance on the application of the ALDT.

If you have questions on any of the above, please contact Infrastructure Partnerships Australia's Head of Economics & Policy, Robert Montgomery at Robert.Montgomery@infrastructure.org.au

Sincerely,

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