Thin Cap and Transfer Pricing Reform
07/06/2023

CCH Learning:

Hello, everybody, and welcome to today's webinar, Thin Cap and Transfer Pricing Reform. My name is Susannah Gynther from Walters Kluwer CCH Learning, and I will be your moderator for today. A few quick pointers before we get started. In the Handouts Section, you'll find the PowerPoint slides for today's presentation. If you're having some sound problems, please check your audio settings, try to toggle between audio and phone, and just a reminder that within 24 to 48 hours you will receive a notification for the e-learning recording. You can ask questions at any point during the presentation by sending them through the Questions pane. Those questions will either answer through the presentation or collate them and ask them at the Q&A towards the end of today's presentation.

CCH Learning also offers a subscription service, which many people have termed Netflix for professionals. It provides members with access to our entire library of recordings, as well as live webinars, for a competitive flat fee. That's for over 500 hours of content. For CPD purposes, your viewing is logged automatically.

Your presenters today are Dritton Jemmalay, director of TP Benchmark Proprietary Limited, and Lachlan Maguire, managing director of GreenMount Advisory. Dritton is the director of TP and International Tax Specialist Advisory Firm, servicing multinationals accounting and law firms of all sizes. Dritton has 15 years of dedicated transfer pricing and international tax experience, with over a decade of practice in the Big 4 and a number of years in-house with some of Australia's largest list of companies. Dritton and his senior team provide clients with technically robust and commercial advice. Lachlan is the managing director of GreenMount's M&A Tax Advisory team, with over 16 years of experience in providing tax advice to domestic and international investors in relation to their structuring and due diligence matters across all elements of the M&A cycle. Lachlan's breadth of experience includes focusing on both turnaround and growth private equity funds, particularly FMCG health and technology, diversified corporate M&A, and infrastructure real estate. I will now pass you over to Dritton and Lachlan for today's presentation.

Dritton Jemmalay:

Thank you very much, Susannah. Is the slides showing? Perfect.

CCH Learning:

Yes, they are.

Dritton Jemmalay:

Thank you, and I just wanted to thank Lachlan again for participating. A bit of background. Lachlan and I were discussing the thin cap reforms, and it became very apparent to me very quickly that he has considered this at a practical level in some detail for a number of his clients, so I thought it would be an excellent value add to this conversation to provide some of his more practical insights. This presentation will be in two parts. The first part will be around the thin cap reform under Division 820, which Lachlan will steer. The second half will be around the transfer pricing reform, which, as we'll see in a moment, has a direct interaction with the thin cap reform and has the ability to limit the debt deductions. I think there are two key takeaways from today's session. One is that

on the thin cap reform, there are multiple tests and that there is the potential for varying outcomes depending on which tests you apply, and I think Lachlan would agree that the devil is in the details, so Lachlan will walk through those various tests today.

On the transfer pricing aspects, we have related party debt. I would say a key takeaway today is that the 30% fixed EBITDA that we've all heard about may well not be your ultimate limitation on interest deductions. There's a possibility for some taxpayers that interest deductions will be limited to an amount less than 30% of EBITDA, which I'll talk to in a moment. With that, as the agenda shows, we'll discuss the thin cap and TP existing rule and proposed report changes first. Then I'll jump onto the TP rule change, which will include a bit of a background in history and in a case study to really flesh out some of these theoretical aspects. With that, I'll hand it over to Lachlan.

Lachlan Maguire:

Thanks, Dritton. It's nice to meet with everyone today. I think it's just very quickly worth touching on some of the existing historical-type approaches to the thin capitalization rules, so I set out on the slide here, there's been, for a long period now, three tests which taxpayers have the option of applying when they're subject to thin capitalization rules. The first one being an asset-based test referred to as the safe-harbour debt test, which is broadly calculated at 60% of the net assets of the relevant thin cap entity or group excluding the debt, typically providing a reasonably stable and consistent approach to a safe-harbour limit of a debt quantum upon which debt deductions can be claimed.

For asset-intensive businesses, this provides certainty, obviously in terms of borrowing, being able to be used to acquire additional assets or help fund the growth of the assets of the business. This has traditionally been a little bit trickier in some of the service-based industries, of course, mitigated by particularly in a transactional sense where there's large amounts of intangible assets like goodwill and brand names, et cetera, which go on the balance sheet, again acknowledging that these tests have been teed off the accounting assets of the relevant entity, again, outside of things like impairments and, I guess, obviously profit and loss, typically providing a pretty clear and clear approach to determining the amount of debt upon which an entity can satisfy or can claim debt deductions.

The other tests which have been available include the arm's length debt test, a bit more of a subjective test but typically used where the safe-harbour may not be satisfied but the debt as a general proposition is arm's length with an arm's length party subject to some subjective analysis.

Finally, a worldwide gearing test, which provides a bit more certainty for some of the larger international groups where the debt may not necessarily all be offshore or onshore and provides a bit of a smoothing mechanism there, Dritton, I don't know if you want to touch on the TP history there.

Dritton Jemmalay:

Thanks Lachlan. The main change, which has been a bit of a sleeper, not talked about too much, is, there is a provision in the current transfer pricing law, Section 815-140, and the effect of that is that the quantum of debt historically has not been subject to the transfer pricing regime. Put simply, the transfer pricing rules or the commission is unable to use the transfer pricing rules to argue that you would've raised a lower quantum of debt. The rules have been limited to allowing the commission to only adjust the interest rate and the price of the debt, and it's quite a nuanced interaction, but the long and the short of it is that transfer pricing respects the 60% safe-harbour, so I'll come to that interaction a bit more later on.

Lachlan Maguire:

Thanks, Dritton. Just to lean in here, we've got a very quick poll to kick us off to ask, "What is the most commonly adopted thin cap measure that you or your clients have been adopting under the existing law?" So I think Susannah is going to pop up the poll here for us. There's an opportunity to select multiple methods if you think that they're ones that have been relevant to you historically.

CCH Learning:

Thank you very much for that, Lachlan. Yes, I'll just launch that poll. What is the most commonly adopted thin cap measure by you or your clients under the existing law? Is it A, safe-harbour, B, arm's length debt test, or C, worldwide gearing ratio? And as mentioned, you can choose more than one option for this poll. If you do use more than one, please indicate that on your poll. Remember, if you do have any questions throughout this presentation, please put those questions into the Questions pane, and we will get to those questions. It's great to see everybody voting, so I'll just give you a few more moments to get your votes in.

Okay, I'm going to be closing the vote. Closing it now, and let's have a little look at what people said. 89% of people said that they used the safe-harbour option, 37% said arm's length debt test, and 11% said worldwide gearing ratio. Back to you, Dritton and Lachlan.

Lachlan Maguire:

Thanks Susannah. It's not probably entirely surprising to see those results. I think, as a matter of practice, that's certainly consistent with our view of the world, overwhelming majority of taxpayers seeking to use the safe-harbour method with some notable use of the arm's length debt test, and I guess for some of the global groups, of course, worldwide gearing comes into play. I guess, just moving on to the changes. At the moment, I guess just to give a quick status update, we had an announcement last year that some changes to thin cap rules would be coming about. This was followed up by an exposure draft law release back in March this year, followed by a consultation period through April. The law is still an exposure draft state and subject to consultation and ongoing review, but it's topical and timely, of course, because the announced start date of these rules is to come into effect from 1 July, so we don't have a final law.

The law is remaining subject to change. Obviously, we can only talk today to what we've seen in that exposure draft released earlier in the year. But I guess, not withstanding that it'd be remiss of taxpayers not to commence thought and planning around what changes might need to be made to their businesses or how it might affect them, I guess teeing off with the safe-harbour replacement, again acknowledging that's historically been an assets-based test, the replacement rule, that'll be repealed, not available anymore. The replacement rule is what's referred to as the fixed ratio test. We'll go into these all in a bit more detail in a moment, but this is effectively an earnings-based test to limit the net debt deductions of an entity to 30% of our concept known as a tax EBITDA. Again, we're immediately moving away from the certainty of asset-based testing to year-on-year testing based on earnings.

No more asset-based tests. I guess, of course, one of the key parts of the presentation today is that, notwithstanding the headline, is quite easy and simple to understand 30% of tax EBITDA. There's obviously a little bit of nuance in that, and particularly some of the changes to the TP rules which have come into play as well, which could affect that calculation. The only other point to note on this one, as noted on the slide, is that there's a potential where there is a denial of debt deductions or net debt deductions under the FRT that they can be carried forward for up to 15 years, subject to, again, some limitations there.

The next one is, of course, the arm's length debt test. So again, noting that there's been some significant adoption of that test historically as a replacement with an external third party debt test, on the face of it, that was originally pretty welcome because, at the announcement stage, the idea that if you could have genuine third-

party borrowing from banks and the like that you would be able to simply claim those deductions without any kind of subjective analysis. Quite welcome. Unfortunately, what's come out in the drafting is that there's a number of very narrow loopholes that need to be jumped through to get into this test, so it does require some pretty careful consideration. Again, we'll go into that in a bit more detail in a minute.

Worldwide gearing, probably not proposing to cover that in a lot of detail today, but that will also be repealed and replaced with a group ratio test, which is basically a referral of group net interest expense to EBITDA ratio on third-party debt only. A couple of other points to note here on the slide, the $2 million de minimis remains unchanged, as does the 90% Australian assets test for outbound investors only. There is an opportunity to elect between the tests on a year-on-year basis, but it's important to note that the secondary tests, the external third-party tests, and the group ratio test are the ones that require an election.

The FRT, the way it's drafted, is the default method, and it will apply unless you make one of these other and can make one of these other elections for the other alternatives. But if you do apply FRT and you have some limitations on debt deductions that you want to carry forward or are seeking to carry forward, if in a subsequent year before you have the opportunity to go back and claim those previously denied deductions you elect into another test, you'll actually lose the opportunity to carry forward those debt deductions. Switching between rules might be suitable if you don't have carry forwards and that's available to you, but separately, it would certainly be something you'd want to think about and be careful.

I think that we'll go into this again in a little bit more detail in a moment. But I think, subject to looking at these requirements, particularly for the external third party debt test, in all likelihood, even where taxpayers might want to use that, the likelihood is that most taxpayers are probably going to find themselves in the fixed ratio test just due to the practicalities of opting into the other alternatives. We'll just take a moment to go through the fixed ratio test. Now, Dritton, if we can just move to the next slide, please. Before we do that, we're just going to quickly grab another poll. Susannah?

CCH Learning:

Certainly. Which measure under the proposed changes do you anticipate is likely to be adopted by you or your clients? Is it A, the fixed ratio test, B, the external third party debt test, or C, the group ratio test? Once again, this is something you can choose multiple answers depending on your circumstances. I'll just launch that poll. If you could please put a click into the button, as I say, you can choose more than one choice depending on your circumstances. Of course, just a reminder, if you do have questions, please put them into the Questions pane, and we will get to your questions either throughout the presentation or at the end. It's great to see everybody voted, so I'm just going to close the vote and let's have a look at what people thought. People thought 84% were going for the fixed ratio test, 26% said the external third party debt test, and 21% said the group ratio test. Thank you very much. Back to you, Dritton and Lachlan.

Lachlan Maguire:

Thanks Susannah. Look, I think, again, not entirely surprising and pretty consistent with the view of what we're seeing practically. Obviously, with the safe-harbour traditionally being the overwhelming method that's adopted, the FRT looks like that's where people are thinking as well, with, of course, the external third party coming into play as well as the worldwide gearing in those other circumstances. We'll just talk to the FRT in a little bit more detail. I mentioned before, it is a default test, so it applies to general investors as defined under the new law, which is a replacement for a broad range of investor categories under the existing law. So it applies where the external third-party test or the group ratio tests are not chosen for a particular income year. The concept is that it'll limit net debt deductions to 30% of tax EBITDA, so we'll just unpack that as well very quickly.

The concept of net debt deductions, as the name suggests, will be a combination of the gross deductions for interest as reduced for any interest income or economic equivalence as it's drafted for the purpose of testing whether the fixed ratio test is exceeded. In practice, obviously, if that means that you're lending any of your borrowings and that's at interest, then that will reduce the amount of net debt deductions, which can be reduced under the fixed ratio test, or cap, I should say.

Then the concept of tax EBITDA, so this is an interesting one. It's obviously designed to try to replicate, as the name suggests, a tax version of accounting EBITDA. But the way that the law's drafted, you'll start with an ordinary taxable income number. You'll add back the net debt deductions, so again, that concept of taking into account interest income as well as expense as well as certain Div 40 and 43 deductions, we'll speak to that in a moment, as well as adding back the tax losses deductions, so not getting penalized for claiming deductions for losses of prior years in terms of working out what is the limit under the fixed ratio test.

One of the curious drafting points that came out through the law, the exposure draft, is that it's only the deductions under Subdivision 40-B, so traditional depreciation as well as all of Division 43 for capital works are included to increase the taxable income, to increase the fixed ratio limit under the tax EBITDA methods, so clearly that is going to... This is subject to consultation, of course, but immediate things that come to mind are things like balancing adjustments and software development pool deductions, won't be able to be added back in terms of calculating the interest limit under FRT.

Other things that could impact it that you might expect are things like 40-880, also not included, black hole deductions, as well as a range of the more niche agriculture and primary production subdivisions within Division 40. Quite a limited scope in there, obviously, one to watch the space on. It's just the ordinary depreciation deductions under Subdivision 40-B that can go to adding back, determining tax EBITDA. The other one which has, I guess, subject to consultation, but at the moment, the drafting of the law would only allow any carry forward of denied interest deductions under the FRT, subject to that 15-year cap, of course, where the continuity of ownership test can be satisfied. This obviously brings it out of line with things like, of course, tax loss deductions, where the business continuity test, same business test and similar business test can be used to justify the carrying forward and deductions of those denied FRT deductions in later years, and as I mentioned previously, it also requires the continuous use of the FRT method.

The other point to note here in practice is, of course, in a transaction and M&A sense, there are provisions in the law that allow denied and carried forward FRT deductions to be brought into a new tax consolidated group as part of a transaction where typically people might see a HoldCo, BidCo, or a new tax consolidated group acquirer acquire a target entity that might have denied deductions carried forward. But those losses or those FRT deductions can only be brought into the new group where the continuity of ownership test is satisfied, so I guess as with any change in ownership, you also won't be able to bring those carry forward deductions into the new group under continuity of ownership test where it wouldn't otherwise be satisfied. This has been an item that's also similar to the various other Subdivision 40 deductions that I mentioned in terms of calculating tax EBITDA, subject to consultation and feedback that's been provided to Treasury around this to see if we can get that broadened to cover BCT as well.

I think we'll just move on to the next slide. Thanks, Dritton. The other one to talk to is the external third party debt test. The intention here is to allow deductions for all debt deductions, so this is a gross basis compared to net for FRT, which are attributable to debt interest, which satisfy the external third-party debt conditions. Notably, the first point here is that the debt interest must be issued to a party that is not an associate or held by an associate. For the purposes of calculating or determining associates under the external third party debt test, the threshold is lowered. Some of you may be familiar that the general concept of associate in the corporate sense, is a 50% interest or sufficient influence. In this context, it's lowered to 10%. What that means is that

there's obviously a very, very low threshold or a very broad net for where lenders might have a very small minority interest in a borrower that would not satisfy the external third party debt test.

Dritton, I think we've just lost that slide there. We've got it back now. Great, thank you. One of the other key requirements is that the debt has recourse only against the assets of the borrower entity, so there can't be any other letters of credit or support from outside the group. That can provide some difficulty, I think, in a practical and commercial sense where you've got particularly offshore parents or fund entities providing letters of credit and guarantees to the group. The final one to note is, the proceeds of the debt must be used wholly to fund assets relating to an entity's Australian permanent establishment or those held for the purpose of producing assessable income.

Given the use of the word relating to in the exposure draft law, I think the key thing there is, it might be clear that, for example, in the case of drawing down funds to fund working capital within an Australian-only group, that's going to be pretty clear and obvious, but if you do have an offshore subsidiary or another entity which is part of the group, it would require some pretty careful consideration as to whether any of that, particularly in a transaction context, any acquisition debt might somehow relate to that foreign subsidiary even if it is only a very, very small portion of the actual Australian target group, so again, a little bit of a hair on that one.

I've noticed this or noted this already, but a choice must be made for a particular year to apply the external third party debt test because again, absent that election, the fixed ratio test does apply, and notably, the choice cannot be made where any associates, again, in the context of this 10% reading of an associate rule, where any associates have not also made a choice to apply the external third party debt test. We think that in practice this is going to provide some pretty high level of difficulty where a corporate group might have a very minor investor with a very small 10% or thereabouts interest in multiple groups. You could end up with a situation where it's just completely impractical for a particular corporate to determine what other investees that investor has and whether they've applied the external third party debt test.

If any other entity which shares a common 10% shareholder has not applied the external third party debt test, then your entity is not eligible to apply that external third party debt test, and you'd have to default back to the fixed ratio test. Again, even if you could know with certainty, given information exchange and the like, who all those other investees were, the opportunity to actually know with certainty year-on-year that they are continuing to make that election into the external third party debt test is likely to provide some quite impractical propositions for the entity.

The only other one just before we move on, Dritton, is one of the other carve-outs from being able to choose the external third party debt test where the thin cap rules would otherwise apply to an entity and they get out of the rules because of either the $2 million de minimis test or the 90% Australian asset test that would also preclude an entity from making the external third party debt test. If there was another entity in that 10% universe which was out of the rules simply by virtue of the $2 million de minimis or 90% Australian asset test, you would also not be able to choose into these rules, so again, we're seeing quite a bit of difficulty in how you might apply these.

Just before we wrap up the thin cap-specific part of the presentation, we'll just move on to the next slide. Thank you, Dritton. I've mentioned a couple of these already, but a couple of points for consideration, just at a minimum, if there is acquisition financing and the target has a foreign subsidiary, even if it is immaterial, whether there may be a view taken that some of that acquisition financing actually related to the financing of the acquisition of that foreign entity.

Again, I've mentioned the 10% threshold for common investor groups, the impracticality of likely being able to determine exactly who all of those other entities which might be subject to thin cap are. Even if you could do that, understanding exactly what elections they have or haven't made year-on-year, and then I think the final

point to note is that again, probably not unsurprisingly, the rules are drafted in a way to preclude shareholders from a company from accessing the external third party debt test where their financing is from shareholders. But that would be the case even if the debt might have historically satisfied the external third party debt test because the debt was with an unrelated creditor. If the shareholder bought that finance, took it on perhaps in an acquisition scenario or perhaps in a restructure scenario, that debt, notwithstanding, it may have originally been arm's length, and something that could satisfy these rules, would cease to satisfy these rules, and you would not be able to include that debt in determining the limit under the external third party debt test.

Dritton Jemmalay:

Am I correct in understanding that, coming back to the fixed ratio test, if you've got a console group and there are specific entities within that group that are deriving losses, the application of a fixed ratio test effectively requires you to add back those individual or loss-making entities or removing it from your console EBITDA account? If so, that sounds like a bit of an achievable but practical burden.

Lachlan Maguire:

That's right. You'd be adding back tax losses for the consolidated group for the purpose of determining the fixed ratio limit for that group.

Dritton Jemmalay:

Yeah.

Lachlan Maguire:

As with all things in tax consolidation, you'd look at it on a group basis.

Dritton Jemmalay:

Okay, excellent. Thanks for that, Lachlan, and please, if you have any questions, just enter them in, and the intention is to allow for it for 5 or 10 minutes at the end to address any questions on both the thin cap and transfer pricing. Before going into too much detail of the transfer pricing, I'm conscious that there'll be varying levels of awareness around transfer pricing concepts, so I thought it might just be worth talking to a couple slides around the real 101 concepts as they relate to related party debt. So when it comes to determining an arm's length interest rate, there are a number of factors that will dictate whether that rate is higher or lower. Rates are obviously a function of economic market circumstances, but within that, certain characteristics of a loan will sway interest rates.

The first one of particular relevance here is a borrower's credit worthiness. You can imagine a high-risk borrower is going to attract a higher cost of funding, and of relevance here, the risk of the borrower is a function of the amount of debt it has, and why that's important will become apparent in a moment. But if you've got more debt, you are a higher risk, and therefore your interest rate at arm's length would be higher, all things equal. The opposite is also true. Lower gearing, lower risk, lower interest rate.

Currency can swing either way. There have been points in time where Aussie dollar debt has been far more expensive than US dollar debt, and those who are familiar with the Chevron case will appreciate that was a significant point in contention given the stark difference in those two currencies as an example.

Tenor, all else equal. In most circumstances, short-term debt is traditionally cheaper than long-term debt. It's almost been the case of most of recorded history at the moment. That might actually not be true given that tenor is really a function of interest rate expectations into the future. If rates are expected to drop, it is possible, and you might see that now where longer-term rates are actually lower than shorter-term rates. But traditionally speaking, a short tenor, a low rate, a long loan are quite a high rate.

Security. As you can imagine, the more valuable the security you provide over a loan, the lower the interest rate should be given, the bank or the lender has some asset to collateralize in the event that you do default.

Ranking. Lachlan was just talking about senior debt. Ranking could be, you could be senior, you could be subordinate to the senior debt, you could be on par. The idea there is, around ranking, as you know is, if you are to default, those that are lenders will basically stack up in a queue to go on, and once the company is liquidated, basically recover whatever they can, call on their security to make hold their debt. Now, you can imagine, if you're at the front of that queue and all that security basically is applied to cover your loan as a lender, there's not going to be much left for others who are ranking below you, so the higher you are ranked in the event of default as a creditor, the lower the rate that senior debt's going to command, and vice versa.

The guarantees. If you have credit guarantees within the group, they have the potential to lower the interest rate, particularly where you're getting a guarantee from a member of the group that is stronger than you are. Practically speaking, the ATO is generally of the view that it's an Australian subsidiary. If you had a foreign parent that is much stronger rated than you, that their argument would be that you'd expect that at arm's length, you would've basically tapped your parent on the shoulder to go and obtain that funding for you because it's cheaper. Whether that's right or not is a separate question, but that's definitely a view at the moment.

Now, I've just talked about what determines an arm's length interest rate. Now what is it that determines the arm's length quantum of debt? So for the arm's length quantum of debt, if we refer to the current arm's length debt tests as providing some criteria, there are two separate tests. One is the could test, how much amount of debt could have you borrowed as a borrower at arm's length from a lender, from a bank? The other test is a would test, that is, how much would you be willing to lend given your specific circumstances?

That's really looking at the investor's perspective because, again, after you've paid your debt holders their interest rate, you've then got cash potentially left over to satisfy your equity investors and ensure that they're achieving a minimum return. What you want to ensure as a borrower is that, yes, you raise an amount of debt that satisfies your lenders and, you're able to repay from the perspective of your lenders, but you also want sufficient cashflow afterwards to satisfy your investor returns and your investor requirements. The could test is very much focused around a bank, will look at types of leverage ratios. How much EBITDA profitability have you got over and above your interest? So they're basically saying, "Okay, at the end of the year, how much profit have you generated?" And they want to know that there's enough there to provide a buffer to ensure that you're going to come good on your interest expense.

Free cash flow is another measure as a percentage of interest that is often used to ensure that that coverage is met. Debt to EBITDA gearing, so on and so forth. They're the type of metrics that a bank or a lender would look at.

Similarly, there might be a credit rating target that the borrower has. You'll see a lot of large listeds out there that say they will not go below what is known as investment grade, which is a BBB- credit rating, and that's a company policy. One of the main reasons for that is, a lot of these large listeds, you pick them out, miners in particular, they're never going to repay the amount that they've borrowed from a bank within the actual tenor within the period that they're due to repay it. What typically happens is that they refinance that, and that debt continues to

roll and roll and roll. To ensure that you can roll over that debt and refinance that debt at the end of its tenor, you typically want to have an investment-grade rating.

The overall credit rating of the business and keeping it at a certain level, which is informed by those kinds of ratios that I talked about so that you're keep enough buffer of interest in income over and above interest, is one factor that might be considered in working out how much debt you could borrow. To put it simply, you can often re-engineer using a credit rating method, what is the amount of debt that tips us over that BBB- or whatever the target credit rating is, and then that becomes your arm's length quantum of debt?

The would test is talking about that, as I talked about before, is a post-interest return to equity holders, and what are your dividend policies? It's no good having a level of debt that doesn't allow you to come put on your dividend policy. Declared dividend, so that's really coming around, coming back to that point around having enough profit to satisfy those shareholders.

Okay, so this TP rule change, what's the fuss? So as I mentioned at the outset of the presentation, as the law stands today, the transfer pricing rules do not allow an adjustment to the quantum of debt, only the interest rate. This specific carve-out is being removed. When the new law takes effect, the transfer pricing rules will be able to operate to determine that arm's length quantum. If the arm's length quantum happens to be less than, say, 60% of assets under the old rule or, going forward, happens to give rise to an amount of debt and therefore interest deductions that are less than 30% of EBITDA, there is a real risk that the transfer pricing rules are in fact going to be the rules that cap out your deductibility of interest on related party debt as opposed to the 30% of EBITDA.

It's really interesting how this will play out. I think there are certain taxpayers that are very cash rich where the change from a safe-harbour asset base to a 30% EBITDA cap will actually result in the ability for far more deductions than under the old safe-harbour test. Within that, I'm expecting that there'll be a number of taxpayers which can satisfy an arm's length debt amount that gives rise to deductions up to 30% of EBITDA. There will certainly be a class of taxpayers that the 30% of EBITDA cap will be ultimately the limit on debt deductions because their transfer pricing can substantiate deductions and a size of debt that gives rise to interest deductions up to or beyond 30%.

For other taxpayers, there is a real risk where, in your industry, if it is not a highly geared industry, if it's an industry with low levels of debt, it's going to be hard for you as a taxpayer to justify that you would've had debt beyond those industry averages. There are many industries, or some industries, at least, where interest as a percentage of EBITDA is far below the 30% threshold. In those particular industries, there is a real risk that we won't come close to the 30% cap, and in fact, the transfer pricing rules will deny deductions at a level below 30% of EBITDA.

Just to make sense of this change, it is quite nuanced. I thought it might be helpful. I'll come to an illustrative example with some numbers in a couple of slides, but I think I find it helpful to look back in history and talk about the development of the old 815-140 protection. How did that come about? And now it's removal. I think the history really does provide some colour to bring it all together, which I'll shortly show through a numerical example. If we would ignore that specific carve-out in 815-140 existed, the way that transfer pricing globally under the OECD framework views the sizing of debt is to ask the question, "How much debt at arm's length would you've been able to obtain as opposed to equity?" And the way the OECD rules set work is to say, "If you would've had 40% debt and 60% equity, then you were limited deduction is on 40%."

The OECD rules effectively deem the delta, the 60, is equity. That is how the OECD works. We've obviously had a 60% net asset safe-harbour here in Australia. I'll come to this in a moment, but you can see the stark difference there automatically, where the gearing at an industry level may well actually be less than that 60% safe-harbour. Under an OECD approach, you'd be capped at whatever the industry gearing is. This approach that I've just

described is one that's adopted in the UK and the USA, so it's not an uncommon approach. We've just had this statutory protection in Australia.

In Australia, in the late 2000s, there was a debate as to how is it possible, how do the safe-harbour rules work in tangent with the transfer pricing rules.

What do I mean by that? The safe-harbour rules were saying that you can borrow up to 60% of net assets. The transfer pricing rules under an OECD framework, which Australia generally follows, as I just said, may give rise to a level of debt that's less than that 60%, so the question was asked, "Hey, I've got a set of TP rules in, at the time, Division 13, saying applying an OECD framework where I could have a level of debt that's something less than 60%." But I've got these safe-harbour rules under Division 820 saying, "Hang on, my deductions are limited to that you cannot deny any deductions up to the 60% safe-harbour." So how do they work? How do I determine my size of debt? There's a lot of debate, there was a lot of public consultation, and in the end it was resolved by the ATO going to seek an independent council opinion from Ron Merkel, QC at the time, who published his position and was available on the ATO site to say, "Look, the safe-harbour is the safe-harbour. The quantum of debt cannot be touched by the transfer pricing rules."

But if at arm's length you could not have obtained 60% of debt, then you've got to go and work out how much debt you could have borrowed. If that's a lesser amount, you then apply the rate of that lesser amount to the actual 60% that you've raised. If you remember back on those 101 concept slides, the more debt you have, the higher the interest rate's going to be, so it's very possible that you've got a 60% rate, which hypothetically, that would've had a very high interest rate. At arm's length, it may have been 40% of debt, which may have meant a lower interest rate, so you apply that lower interest rate to the actual amount of debt, being the 60%.

That was how that was clarified. It was first clarified by the ATO through a Taxation Ruling 2010/7. If you remember that retrospective law in Subdivision 815-A, it was legislated in that law, and then when the current rules came in 815-B, there was that provision that was enacted in 815-A to give effect to that interaction that I've just described, has been maintained through the current law, which is 815-140, which is what is now being removed.

Just to put some numbers to what I just described because it can be a little bit confusing, let's say we've got an example where the safe-harbour debt amount is $200 million and the interest rate at $200 million. A hypothetical amount would be 10%, so you'd have $20 million worth of deductions at a 10% rate on $200 million. Now let's say the arm's length debt amount is actually something less than $200 million. It's $100 million, so it's about half of the safe-harbour debt amount. If had I gone and raised $100 million, it would've been cheaper because there would've been a lower credit risk to the borrower. That arm's length amount would've carried a 5% interest rate, so you'd have $5 million of debt deductions.

Now if you go to the three scenarios I've outlined there on that slide, scenario A, B, and C, scenario A, which is marked by a red dot, you'd have $20 million worth of deductions. As a result of 815-140, we cannot claim that $20 million worth of deductions. Yes, it's within the safe-harbour debt amount, but it's applying an interest rate that is not an arm's length rate having regard to what the borrower could have actually borrowed, that's 5%. B, the OECD approach, which is adopted in the UK and Australia, and the approach which is going to be adopted now in Australia would be to say, "What are the deductions on the arm's length debt amount?"

They're $5 million. $100 million times the 5%. That would give rise to scenario B there, which is $5 million of deductions. Now, importantly, that's where we are going, but where we've been until now is scenario C, this hybrid approach where we say, "Look, we respect the $200 million, but we apply the 5% interest rate." And that gives us $10 million worth of debt deductions. It's a bit of a hybrid approach that applies an arm's length interest rate to the actual amount of debt. You can see how that gives rise to very different answers. We've had a lot of

situations to date under the existing law where you deduct your $10 million and that would potentially wipe out any level of taxable profit in the business, and that's effectively been permitted statutorily.

What this new provision will say is, "Hang on, your arm's length debt amount, again having regard to that lender and borrower test, is $5 million." That would necessarily, by definition, mean that's an amount that means we would've borrowed that and we would've left a sufficient return to our equity investors, so that you would expect that the arm's length amount of debt basically leaves taxpayers more often than not in a profit position, which wasn't a guaranteed outcome under the existing provisions.

I'll hand it over to Susanna, but this is a bit of a quiz just to assess how closely you've been paying attention. I've got a scenario here applying what I've just described, what is the arm's length debt capacity for a taxpayer, the could test? So the industry average debt to EBITDA is 3:1 times, and the tax EBITDA for a taxpayer is $100 million. With that, Susanna will chuck up a poll, what is the arm's length debt amount, given those two facts?

CCH Learning:

Thank you for that, Dritton. I'll just leave that there for a moment so everyone can get the facts into their heads. Then I will launch the poll. This one is a one-choice only poll, so please put in what you think would be the arm's length debt capacity for the taxpayer given that the debt EBITDA industry average is 3:1 and the tax EBITDA for the taxpayer is $100 million. I'll just give you a few more seconds to get your votes in.

Just a reminder that if you do have any questions, please put them into the Questions pane, and we'll get to those questions shortly. Okay, I'm about to close the poll. All right, let's see what people thought. The answers that I got were, 70% said A, $300 million, and 30% said C, $100 million. Back to you, Dritton.

Dritton Jemmalay:

Thanks, Susannah. The point here is that the answer is $300 million. If the taxpayer has EBITDA of $100 million and our measure of an arm's length debt amount is that 3:1 ratio, that means I could raise three times $100 million in debt, which is $300 million. Building on this example, what would the limit be for this taxpayer as determined by the fixed ratio test? So we have a tax EBITDA of $100 million and a fixed ratio test of 30%. This isn't a trick question, but it would really just highlight this interaction, so again, Susannah, I'll hand it over to you.

CCH Learning:

Thank you, Dritton. I'm going to launch that poll. Again, please, this is just a single-choice poll, so what is the limit on debt deductions as determined by the fixed ratio test if you taxed EBITDA for the taxpayer is $100 million? So please put a click in the radio button that best describes what you think is the answer. Just a reminder, if you do have any questions, please put them into the Questions pane. All right, so I will be closing that vote. I'll just give you a couple more seconds. Now I'm closing the vote. Let's have a look. 90% said A, $30 million, 5% said B, $25 million, and 5% said C, $20 million. Back to you, Dritton.

Dritton Jemmalay:

Thanks Susannah. Yes, so we've got a 30% fixed ratio. As Lachlan explained, this is obviously a gross simplification of the test, but if we've got $100 million of tax EBITDA and the fixed ratio test is 30%, we're going to be allowed deductions up to $30 million of interest, 30% of that EBITDA. The point here is the $300 million arm's length debt amount, the $30 million fixed ratio test limitation on interest.

Now, the question is, what's the amount of allowable debt deductions for the taxpayer when we consider the application of both the TP rules and the fixed ratio test? So we've established that $300 million is an arm's length debt amount. We've established that tax EBITDA for the taxpayer is $100 million, and therefore their fixed ratio test allows up to $30 million of deductions. Now I'm going to throw in an additional fact here. We've got $300 million of arm's length debt capacity, but the arm's length interest rate is 5% on that debt. What are the arm's length debt deductions under the transfer pricing rules? Hint, it'll be the arm's length interest rate times the arm's length debt amount. What is that number, and how does that compare to the fixed ratio tests? And given those two of $30 million, and therefore, what is the amount that is deductible under both the TP and fixed ratio tests? I'll hand that over to you, Susannah, for a final poll.

CCH Learning:

Thank you for that, Dritton. What is the amount of allowable debt deductions for the taxpayer given those conditions, I'll call it? Is it A, $15 million, B, $30 million, or C, nothing? So I'm going to launch the poll. I'll just give you a moment there to consider the conditions, and I'm going to launch the poll. Please, click the radio button with the answer that you think is correct. This is just a one-choice answer once again. Just a reminder, if you do have any questions, please put them into the Questions pane, and we will get to those questions very shortly. It's great to see everybody voting, so I'll just give you a few more seconds to get your votes in. Okay, I am going to close the vote. Let's have a little look at what people thought. 86% said A, $15 million, and 14% said B, $30 million. Back to you, Dritton.

Dritton Jemmalay:

Thanks Susannah. It's nice to see that everyone wants to claim a deduction, so zero is definitely off the table. The answer here is $15 million. This is a scenario that really highlights the crux of today's presentation, which is, you may well have $30 million of deductions allowable under the fixed ratio test, but your transfer pricing is only allowing 5% of 30, which is $15 million of deductions. What's the lesser of the two? The transfer pricing amount. If you've got related party debt of $300 million, and that's the arm's length rate, you're going to be limited to $15 million of debt deductions. Not withstanding that your fixed ratio limit is $30 million, and that is really the key takeaway from that slide, that your 30% of tax EBITDA may well not be a limit on debt deductions if your arm's length debt deductions of transfer pricing are less than the 30% of EBITDA.

Just to close it out and over to you, Lachlan, if you wanted to add any further points to this, I think, what does all this mean practically? What should you be doing as either an advisor or as a taxpayer? I think the obvious first point is to start modelling how do the different tests apply. Assessing which tests you fall within and how the deductions stack up under the three different tests and the transfer pricing limitation. To work out that transfer pricing limitation, you're going to need to undertake an arm's length debt sizing, which is effectively somewhat equivalent to applying the arm's length debt test for your current position. Not with saying that you may well be within the safe-harbour debt as it stands today, and that would've been appropriate because you wouldn't have had much cause to consider what is the arm's length debt amount given you've got the safe-harbour protection beyond how it might have impacted that interest rate.

As a practical question, when I discuss this with clients, they're asking, "How often are we going to have to size this debt? Is this an annual sizing, is there a sizing at issuance only, i.e., when you raise the debt?" The UK, obviously years ahead of us on this, and they've put out a position which says that you do a sizing when the loan was issued and then you do some testing year-on-year just to assess that you're within a certain level of covenants, which will hopefully end up being the case here in Australia. I'm expecting some guidance from the ATO that, hopefully, is along those lines. Otherwise, it will be quite a significant burden on taxpayers to assess that annually.

Then obviously, if you are working out that your existing debt, new rules, existing debt balances end up resulting in denials, it's probably worth thinking about a resizing of that debt because withholding tax may also apply if you maintain that quantum of debt. Obviously, the part rate, that potentially becomes relevant when you're considering a debt restructuring. I think there's a real question around, do you need to be reconsidering your capital structure in light of these new rules if the test is suggesting less than a 30% of tax that you would account? Lachlan, did you have anything to add to that before we hand over for questions in the final couple minutes?

Lachlan Maguire:

No, I think that's well covered, Dritton. Just reiterating, I think, the point, now's probably the time to be looking at financial forecasts and having a think about, particularly how the fixed ratio test as a default is going to apply to you and particularly where there's related party debt in that, as you say, we can give that some thought in terms of the arm's length sizing principle.

Dritton Jemmalay:

Thanks, Lachlan. Ms. Susannah, over to you to flesh out any questions that we might have got through the course of the presentation.

CCH Learning:

Not a problem. Thank you very much to both Dritton and Lachlan. I will just take that back for all the moment. Yes, we will be spending the next few minutes taking questions, so just a reminder to please type them into the Questions pane. We have a few already, but that's okay. If you have a question, please put it in. To give you some time to type those up, I will mention our upcoming webinars.

Just to let you know, we're looking at the new $3 million super tax. We're also going to be looking at aged care for high-net-worth individuals and, of course, those for-profits, getting ready for the 30 June reporting season. We'll be talking about preparing clients for mediation involving relational conflict and how to encourage your clients to pay with grace and ease, those late invoices. We'll be also looking at the investment strategy you must have for your SMSF.

If you're interested in any of these, please head to our website at wolterskluwer.cchlearning.com.au and have a look and see if they might be something you would be interested in. Let's have a little look at our questions. Just hold on a moment. I'll just make it a bit bigger so I can see the questions.

Okay, so I have a question from Shreyas. Shreyas is asking, "Can a taxpayer who has a related party debt, even if only $1, use the external third party debt test to support at least third party debt deductions, or is there a limitation that denies such a taxpayer having any related party debt from using the external third party debt test?"

Dritton Jemmalay:

I'd be keen on Lachlan's thoughts, but my immediate response would be, if you want to apply the external third party debt test, any related party loans or associates clearly are out of scope of that test, so applying an external third party debt test, you'll lose, I think, your ability to basically claim deductions on related party debt, I think, is the short answer. If you want to try and claim both, you're related party and third party, you're no longer in the third party debt test, you're therefore subject to a slightly higher degree of subjectivity in a review by the ATO, and then the task becomes proving that, at arm's length, you could have raised both the third party debt test, the third party debt amount, and the related party debt amount. But you'd want to be pretty sure that your arm's

length debt amount allows buffer over and above that third-party debt amount. Otherwise, you're giving way to what's an almost guaranteed deduction, I'd say.

Lachlan Maguire:

I'd endorse those comments, Dritton. I think the point here is that if you're needing to apply or wanting to apply the external third party debt test, it's only going to cover debt deductions for debt interest, which satisfy the relevant conditions. Obviously, the related party debt is not going to satisfy those conditions, so you can immediately rule out any deductions on that if you're choosing that method. Also, just reiterating my comments before about the 10% universe of corporate groups where it's a one-in, all-in, or, I guess, more importantly, one-out, all-out, in terms of being able to apply that test, if you find yourself as the ugly duckling in the group that wants to not apply that test, that could cause some tension. But the key answer is yes. It won't cover the related party borrowings if you would choose that test.

Dritton Jemmalay:

Thanks, Shreyas, and a good question. I had a Dorothy Dixon, which was almost identical, so thank you. We've lost you, Susannah. I think you might be on mute.

CCH Learning:

Apologies. I did not take myself off mute. Apologies for that. I have a question from Walter. Walter is asking, "Are SMEs subject to the TP provisions?"

Dritton Jemmalay:

Yes is the short answer. There are practical compliance guidelines from a transfer pricing perspective. It's a really good question. There are practical compliance guidelines that give you a safe-harbour of sorts for the rate historically, but there's obviously nothing to date that gives you any protection over the amount, so it's a really good question as to, will you have this protection over the rate, this safe-harbour, assuming you satisfy the criteria, but you're still subject to this onerous analysis from a Division 820 think cap perspective? I don't know. It'd be interesting to see if they broaden the practical compliance guidelines, which I would hope they do, to consider quantum under Division 820.

CCH Learning:

Thank you for that, Dritton. There you go, Walter. Yes and no on that one, but we might have to wait and see. I have another question from Shreyas, who was asking, "For the TP rule change, if a taxpayer meets the 30% tax EBITDA condition, do they mandatorily need a TP analysis and documentation to be paid in order to still claim the interest deductions that is less than 30% tax EBITDA?"

Dritton Jemmalay:

Good question. Absolutely, yes, is the short answer to that. There'll be an onus to maintain documentation to support your position from a transfer pricing perspective. Currently, the position is, you're required documentation prior to lodging your tax return in order to be legible for penalty protection, so if you want to avoid penalties in interest and you want to substantiate your position from a TP, then absolutely yes.

CCH Learning:

Thank you for that, Dritton. There you go, Shreyas. That is something you might have to keep up with on your documentation. I have a question from Graham. Graham is asking, "How will the thin cap impact developers that borrow from related parties?"

Dritton Jemmalay:

Sorry, what was that? Sorry again, Susannah. The line is broken.

CCH Learning:

I'll say it again. That's all right. How will the thin cap impact developers that borrow from related parties?

Dritton Jemmalay:

Developers, okay. I assume that's a property developer. I think-

CCH Learning:

I'm sorry. That's all the question says.

Dritton Jemmalay:

Yeah. I assume that's property developers, which... Or let's just talk project-type scenarios where you probably don't have a lot of profit for a number of years and then, in time, you'll-

CCH Learning:

Yes, the property developer. Graham is saying yes.

Dritton Jemmalay:

Profitable. Yep. Lachlan, I'm keen for your insights too, but I think the fixed ratio test will kick you out where your EBITDA is basically in a lost position, so it's no longer... Basically, your limit is zero. If you're a property developer and you are in construction, you are in development, you haven't yet got any income coming from that site, which is a very typical scenario for any large project, infra project, development project. Your fixed ratio test will limit you to zero. Your transfer pricing may well and should allow some level of debt deductions, but I think that in that instance, the fixed ratio tests will ultimately trump transfer pricing, so I think you limit it to zero.

Lachlan Maguire:

I think that's right. It's probably just practically worth pointing out that even if you were able to satisfy the external third party debt tests and claim those deductions, all you're going to end up with is tax losses as compared to carry forward denials under the FRT rules, so I guess what would be the benefit there? If you end up with actual deductions that can be claimed and losses, then, of course, you've got business continuity tests available to you to carry those forward that you don't have if it's just a carry forward under the FRT.

CCH Learning:

Thank you very much for that, Dritton and Lachlan, and I hope that helps you out there, Graham. Anthony had a question. He asked, "Any insights into the likelihood of the commencement date remaining at 1 July 2023 given the uncertainty of the law and the imminence of this date?"

Lachlan Maguire:

I might take that one, Dritton, if you're okay with that, but I think notwithstanding where we are, and it's a very reasonable question to be asking, the feedback suggests that the government and treasury is holding firm on that commencement date, so there's a world where the war comes into place after that date and it looks a little bit different to the exposure draft we've already seen. There's a range of concessions being asked for right across various industry groups. But the feeling is that a deferral is probably unlikely to be granted on this, as would be any grandfathering of his existing arrangements. We're notwithstanding that, because the rules will apply to full-year deductions across all of F.Y. '24. Obviously, it's not utopia to be having these rules come in and potentially in a changed way after commencement date. It never is, but there is time to consider your affairs before the end of the year, potentially, in a meaningful way.

CCH Learning:

Thank you for that, Lachlan. There you go, Anthony. It looks like this train is not going to be stopped. Just our last question here from Giovanni, "What is your view on how the rules affect REIT's head-trust borrowing and each sub-trust owning real estate assets given a trust cannot form an income tax consolidated group?"

Lachlan Maguire:

Maybe just to tear it off. The thin cap rules, if they apply, they can still apply to trusts. We've obviously talked about it in the context of corporate groups today, given that's the expected majority, but I think equally, you can take all the comments that have been made today around that as read in the context of a trust or a REIT as well.

CCH Learning:

Okay.

Dritton Jemmalay:

Yeah, I think a dumb question for our speaker, Lachlan, is, do you get tripped up by the associate issue there in a trust structure?

Lachlan Maguire:

Yeah, that's right. The associate rules don't just apply to corporates. They apply to trust as well. There's actually broader rules under the trust provisions of associate. But as a base case for a fixed unit trust, you can again take those comments as read in the context of a unit holder vis-a-vis a shareholder.

Dritton Jemmalay:

Giovanni, from a TP perspective, what would happen at around arm's length is, usually, you'd get security up to head trust from all the sub-trusts in that structure. It's facts and circumstances, but it wouldn't be uncommon to look at it from a TP perspective as a quasi-consolidated P&L and balance sheet, given the security that you may or guarantees that you may get at arm's length in that kind of a structure.

CCH Learning:

Thank you very much, Dritton and Lachlan, for that answer. I hope that does help you there, Giovanni. That does bring us to the end of our questions for today. In terms of next steps, I would like to remind you all to please take a moment to provide your feedback when exiting. We've asked you a couple of questions about today's webinar, so it's really important for us to hear your opinions. It's also a reminder that within 24 to 48 hours you will be enrolled into the e-learning recording, which can be watched multiple times, and have access to the PowerPoint, transcript, any other supporting documentation, and of course a CPD certificate. I would very much like to thank Dritton and Lachlan for the session today and to you, the audience, for joining us. We hope to see you back online for another CCH Learning webinar very soon. Enjoy the rest of your day. Thank you very much.

Dritton Jemmalay:

Thanks everybody. Bye-bye.

Lachlan Maguire:

Yep.