Thin Cap and Transfer Pricing Reform

Dritton Jemmalay &
Lachlan Maguire

Wednesday 7 June 2023

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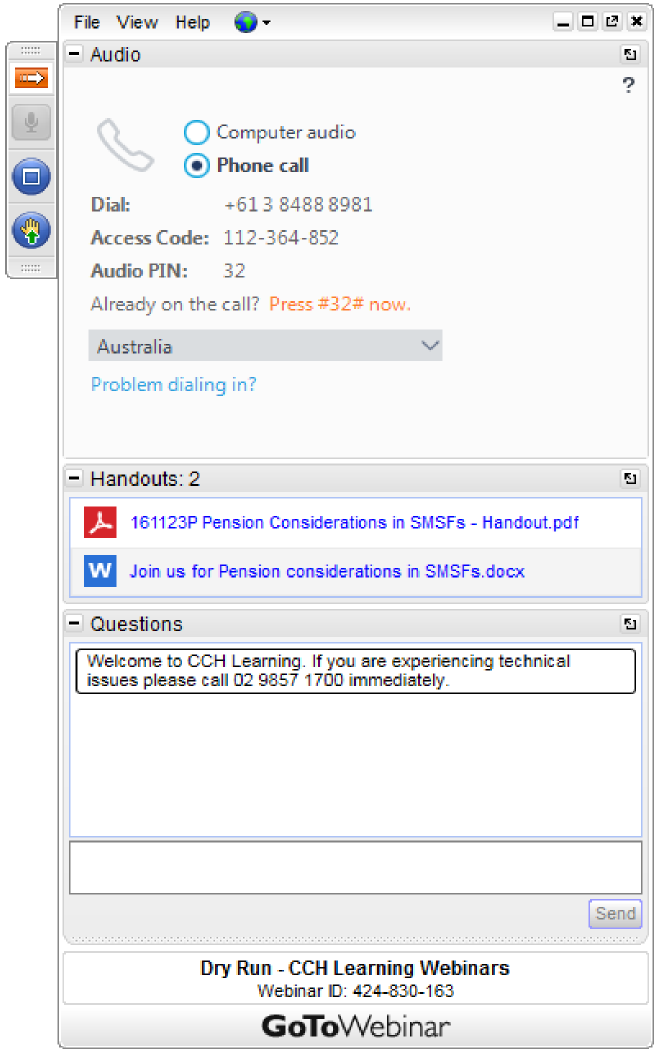

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Susannah Gynther
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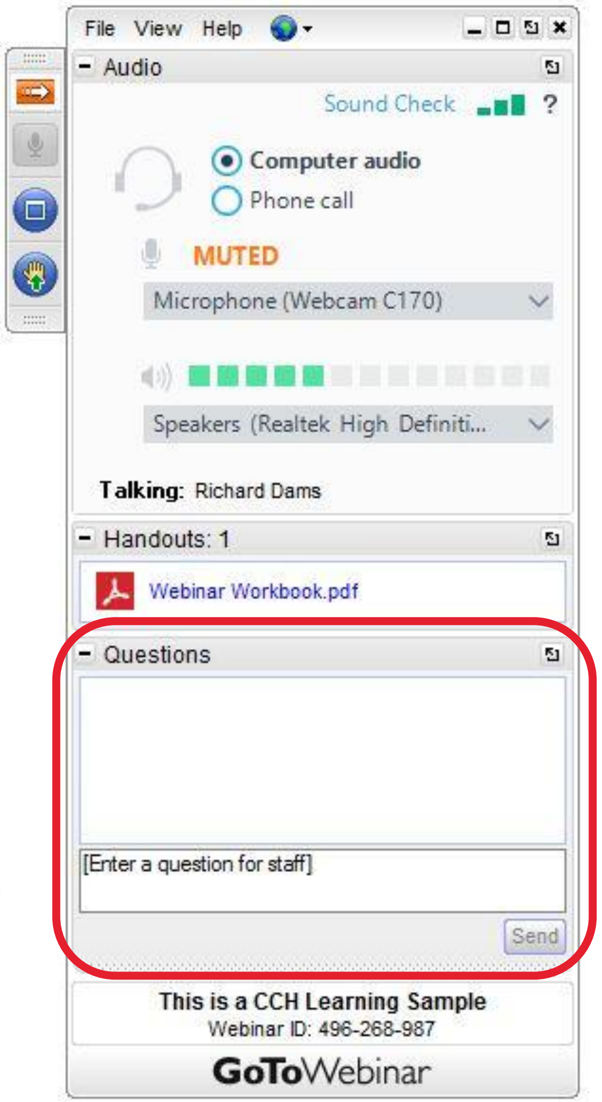

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Your Presenters

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- Director
- TP Benchmark

- Lachlan Maguire
- Managing Director
- GreenMount Advisory

Today's session will cover

Thin cap and Transfer Pricing Reform

- Thin cap and TP – Existing law & proposed changes
- TP rule change - What's the fuss?
- History of existing TP & thin cap interaction
- Practical application – Proposed law changes

Thin cap and TP - Existing law

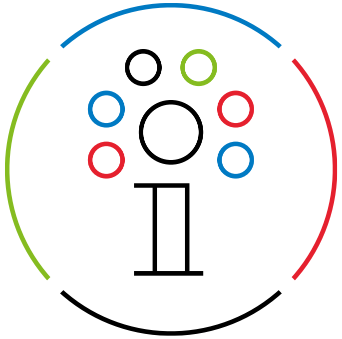
Existing law

- For non-ADI's, existing thin capitalisation measures available to taxpayers include –
  - Safe-harbour (60% of net assets (excluding debt))
  - Arm's length debt test
  - Worldwide gearing ratio test[1]

- TP rules (Section 815—140, 1997 Act) limit the operation of TP rules to an adjustment of the rate of interest, and <u>not the quantum of debt.</u>

1. Available to outward investors that are not also inward investment vehicles

What is the most commonly adopted thin cap measure by you or your clients under the existing law?



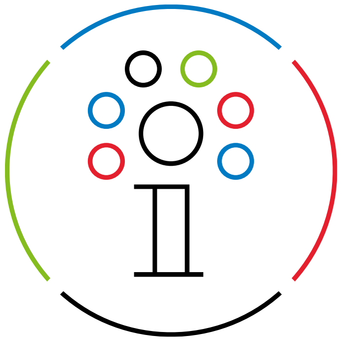
a) Safe harbour (60% of net assets)
b) Arm's length debt test
c) Worldwide gearing ratio

Thin cap – Proposed law changes

Existing measure	Proposed replacement	Comments
Safe-harbour (60% net assets)	Fixed Ratio Test ("FRT") - net debt deductions limited to 30% of tax EBITDA	No longer safe harbour - applies after TP rules. Potential for 15 year carry forward.
Arm's length debt test	External Third Party Debt Test ("ETPDT")	Narrow application requires careful consideration
Worldwide gearing ratio test	Group Ratio Test ("GRT")	Group net interest expense / EBITDA ratio on third party debt.

- $2m de-minimis remains unchanged.
- Annual election between tests possible, but opting out of 30% limitation results in loss of carry-forwards.
- Indications are that the fixed ratio test (30% interest to EBITDA cap) will apply to a significant number of taxpayers.

Which measure under the proposed changes do you anticipate is likely to be adopted by you or your clients?



a) Fixed ratio test
b) External third party debt test
c) Group ratio test

Thin cap – Proposed law changes

Fixed Ratio Test

- Default test – applies to 'general investors' where ETPDT or GRT are not chosen for a particular income year
- Limits *net* debt deductions to 30% of "tax EBITDA"
- *Net Debt Deductions* – gross deductions will be reduced for any interest income (or economic equivalents) for the purpose of testing whether the FRT is exceeded
- *Tax EBITDA* = taxable income + net debt deductions + certain Div 40/43 deductions + tax losses deducted
  - Only deductions under Subdivision 40-B (as well as Division 43) are included to increase taxable income in determining Tax EBITDA
  - Deductions under other areas of Division 40 are not included (e.g. balancing adjustments, software development pools, primary production and black hole deductions)
- Any deductions denied under FRT may be carried forward for up to 15 years, subject to satisfaction of Continuity of Ownership Test (but not Same Business Test) and continuous use of FRT method for intervening income years

Thin cap – Proposed law changes

External Third Party Debt Test

- Allows deductions for all debt deductions attributable to debt interests which satisfy the ‘external third party debt conditions’
  - Debt interest must be issued to a party that is not an ‘associate’, nor held by an associate
  - Recourse only against assets of the entity
  - Proceeds used <u>wholly</u> to fund assets relating to an entity’s Australian permanent establishment, or those held for the purpose of producing assessable income
- A choice must be made for a particular income year in order to adopt ETPDT. The choice cannot be made where any associates (see below) have not also made a choice to apply the ETPDT
- “Associate” for these purposes takes ordinary s318 meaning, but with control stakes substituted with 10%

Thin cap – Proposed law changes

Consider:

- Acquisition financing where the Target has an immaterial foreign subsidiary
- Corporate groups with 10% investors who may have portfolio interests in other entities that are also subject to thin capitalisation
- Corporate groups with unrelated party financing arrangements (senior facilities), where a buyer acquires both the debt and equity interests in that corporate group

TP – 101 concepts for related party debt analysis

- The key determinants of arm's length interest rates are as follows –

Factor	Impact
Borrower creditworthiness	Lower creditworthiness, higher the interest rate (visa-versa)
Currency	Impact varies depending on macro-economic circumstances
Tenor	Typically, shorter the tenor, lower the interest rate (visa-versa)
Security	Security *may* lower the interest rate
Ranking	More senior the ranking, lower the interest rate (visa-versa)
Guarantees	Guarantees *may* lower the interest rate

TP – 101 concepts for related party debt analysis

Key determinants of arm's length debt capacity –

- Could test': the amount of debt that a borrower could borrow at arm's length (lender perspective)
  - Satisfaction of target credit metrics eg EBITDA / interest, debt / EBITDA, gearing etc.
  - Credit rating target (eg not lower than a BBB-)

- 'Would test': the amount of debt that a borrower would borrow at arm's length (investor perspective)
  - Post interest returns to equity holders
  - Dividend policies

TP rule change – what's the fuss?

- TP rules (Section 815—140, 1997 Act) limitation **removed**. TP rules will operate to determine arm's length **quantum of debt** and will operate to deny deductions **before** the 30% limitation.

  NB Unlike 60% safe harbour which 'guaranteed' deductions on all debt balances up to 60% assets.

- Accordingly, under the fixed ratio test, related party interest deductions will be limited to the lesser of –
  a) 30% of EBITDA, and
  b) interest deductions based on an arm's length quantum of debt under TP.

- Therefore, if comparable company gearing implies arm's length interest expense / EBITDA < 30%, there could be interest denials before the 30% limitation applies.

- For some taxpayers, this will result in interest deductions being limited to less than 30% of EBITDA by TP, and for others 30% of EBITDA.

History of existing TP & thin cap interaction – OECD approach

- It is established OECD TP practice that a taxpayer's related party funding should be 'accurately delineated' (ie characterised) as either debt or equity based on the substance and form of the arrangements.

- Practically, this is determined by asking the question 'How much debt [as opposed to equity], could (and would) a taxpayer raise operating independently at arm's length'?

- Accordingly, under the OECD approach, taxpayers are required to undertake an arm's length debt analysis for all related party debt issuances, and treat any excess debt as equity. This approach is adopted in the UK and USA.

History of existing TP & thin cap interaction – Australian approach

- In the late 2000s there was significant debate around how the TP rules interact with the thin capitalisation rules (Div 820) in Australia.

- That is, Division 820 prescribed a safe harbour debt amount (then 3x debt to equity), however the OECD TP approach deemed non-arm's length debt as equity. So the question was 'What happens if the arm's length debt amount is less than 3x equity? Do the TP rules trump Div 820 and limit the quantum of debt deductions?'

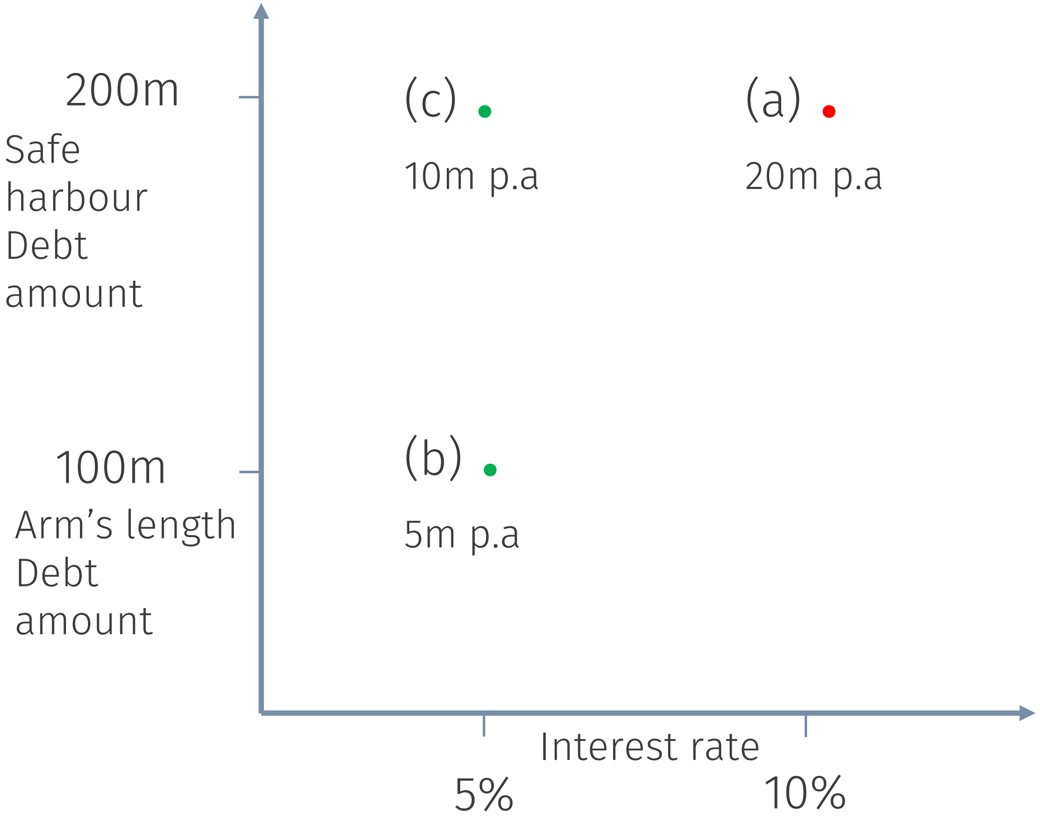
- The ATO resolved the uncertainty by obtaining Counsel opinion and publishing TR 2010/7 (which was later enacted into law, both in 815-A, and the current 815-B ie s 815-140).

- The answer was – <u>TP cannot limit the quantum of debt</u>. TP only limits price (ie interest rate). Therefore apply the arm's length interest rate, based on an arm's length quantum of debt, to the debt actually issued (see next slide for an illustrative example).

Practical application - Existing versus proposed TP rule changes

Illustrative example –

1) 60% Safe harbour debt amount is 200m @ 10% interest rate.
2) Arm's length debt amount is 100m @ (lower) 5% interest rate.



Scenario	820 & TP interaction	Annual debt deductions
(a)	Hypothetical cost of 60% safe harbour debt	20m (10% x 200m)
(b)	OECD & proposed Australian approach	5m* (5% x 100m) *Subject to 30% EBITDA limitation
(c)	Current Australian approach (815-140)	10m (5% x 200m)

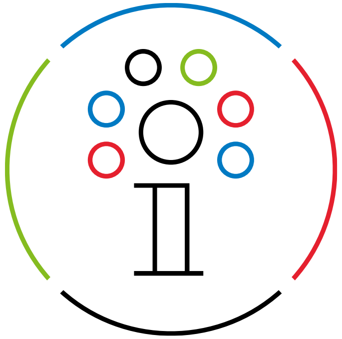
What is the arm's length debt capacity for the taxpayer (the 'could' test)?

a) $300m
b) $200m
c) $100m

- Debt / EBITDA industry average is 3:1x
- 'Tax EBITDA' for the taxpayer is 100 million.

What is the limit on debt deductions as determined by the fixed ratio test?

a) $30m
b) $25m
c) $20m



- ‘Tax EBITDA’ for the taxpayer is 100 million.

What is the amount of allowable debt deductions for the taxpayer?

a) $15m
b) $30m
c) $0m

- Debt / EBITDA industry average is 3:1x

∴ $300 million arm's length debt capacity

- 'Tax EBITDA' for the taxpayer is 100 million

∴ Limit under fixed ratio test $30m

- Arm's length interest rate is 5%.

∴. Arm's length debt deductions are ???

Key takeaway

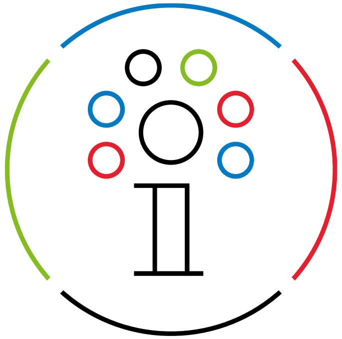
- 30% of ‘tax EBITDA’ may not be the limit on debt deductions if arm’s length debt deductions under transfer pricing are < 30% of tax EBITDA.

Practical application – Managing your position

- High level modelling should be performed to assess how the thin cap reforms apply, including how debt deductions compare under each of the tests.
- An arm's length debt sizing analysis should be performed for related party debt issuances to assess how quantum of arm's length debt deductions under TP compares to fixed ratio test.

  NB: Practical questions arise as to the frequency of such a debt sizing analysis. There are reasonable grounds for arguing sizing upon issuance / refinancing, and then covenant testing annually thereafter.
- If TP limits debt capacity and interest deductions to < 30% of tax EBITDA, consideration should be given to a resizing of the debt, and collateral tax considerations (eg Part IVA, withholding tax etc).

Questions



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Or contact me via:

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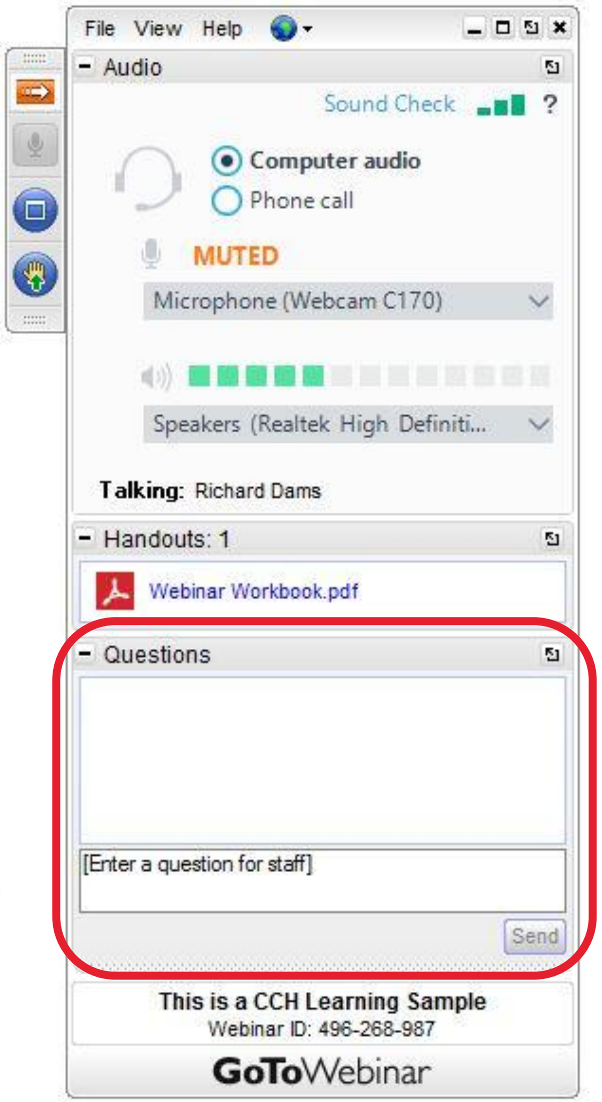

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Questions

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