Australian Private Equity &
Venture Capital Association Limited

6 June 2014

Mr Tom Reid
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Law Design Practice
Revenue Group
The Treasury
Langton Crescent
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By email: taxlawdesign@treasury.gov.au

Dear Tom,

Thin Capitalisation Reforms – Exposure Draft Legislation

The Australian Private Equity and Venture Capital Association Limited (**AVCAL**) welcomes the opportunity to comment on the *Tax and Superannuation Laws (2014 Measures No. 3) Bill 2014* exposure draft (**ED**) law released by the Assistant Treasurer on 8 May 2014 which deals with changes to the Australian thin capitalisation rules.

AVCAL represents the venture capital (**VC**) and private equity (**PE**) industry in Australia, which has a combined total of over $24 billion in funds under management for domestic and offshore investors. VC and PE firms invest billions of dollars in early stage and established businesses spanning many sectors across the Australian economy. These investments help to support around 500,000 jobs, and contribute over 4% every year to our national economic output.

AVCAL believes that is important that Australia provides to local and international investors an efficient and competitive environment for the financing and funding of investments.

Investors need certainty regarding the national laws and regulations – especially in relation to tax – before they will put significant capital to work in specific jurisdictions over a long-term period.

The changes to the thin capitalisation rules in the ED will require investors to review and restructure their financing arrangements regarding their Australian investments within a very short time frame. In particular, given that the ED sets out significant changes to the safe harbour thresholds without transitional or grandfathering relief, investors will now have to consider whether they can utilise the alternative Arm's Length Debt Test (**ALDT**) for their existing and future investments in Australia from 1 July 2014.

However, there are flaws in the ALDT regime – particularly the current requirement that the ALDT has to be tested each year – which makes the ALDT problematic for long-term investors to rely on for certainty. In spite of this, more tax payers will now be forced to rely on the ALDT as the reduced safe harbour debt ratio (of 60%) will not suit every taxpayer or industry, particularly those involved in the property and infrastructure industries, and those taxpayers that have large quantities of unbooked goodwill but strong cash flows.

The ALDT regime is currently being reviewed by the Board of Taxation (**BOT**). The BOT is only scheduled to put forward its recommendations to Government in December 2014, and any changes adopted will take time to come into effect. This leaves a substantial gap in the intervening period between the commencement of the new safe harbour thresholds and the Government's response to the BOT's ALDT review. This means that companies seeking to review and restructure their financing arrangements – a costly and time-consuming exercise – cannot do so with certainty as to the tax outcome utilising the ALDT regime.

Given that the ALDT was introduced as part of the thin capitalisation legislation in 2001 for taxpayers who fail the safe harbour test but who are able to achieve higher gearing levels from external third party financiers due to either strong cash flows and/or industry comparisons of the borrower, the Government needs to consider the ALDT in conjunction with the reduction in the safe harbour and worldwide gearing thresholds. If not, there will be significant uncertainty as to the tax deductibility of the interest incurred under taxpayers' arms-length debt if the ALDT is used during this period.

Therefore, AVCAL believes it is critically important that Treasury and the Government adopt a holistic approach to the implementation of changes to tax law, as opposed to a piecemeal approach.

AVCAL proposes that, to mitigate the negative impacts to investment on the pending thin capitalisation changes, Treasury should recommend to the Government that there be a deferral of start date of the ED to align with the enactment of any rule changes arising from the ALDT review (or until Government confirmation that no changes will arise from the ALDT review). It is vitally important that the timing of any changes to the thin capitalisation regime are coordinated and implemented in an orderly manner, so that the taxpayer has certainty of tax outcome during this transition period.

In addition, as outlined in AVCAL's previous submissions on thin capitalisation reforms (see AVCAL's submission of 25 September 2012 to the Business Tax Working Group Discussion Paper of 13 August 2012), **the thin capitalisation reforms outlined in the ED should not be implemented without transitional or grandfathering relief for taxpayers with existing debt facilities, for the natural term of those facilities**.

Such an approach would be consistent with longstanding principles relating to tax changes having prospective rather than retrospective effect. It would also be consistent with the Government's stated approach to tax policy, namely that it is strongly opposed to the retrospective application of tax reforms as it creates uncertainty and raises strong concerns from overseas investors about sovereign risk in Australia.[1]

Specific drafting comments reflecting the above submissions are outlined below.

Commencement date

The start date of the thin capitalisation reforms should be deferred to 1 July 2015, or later if necessary to ensure alignment with any reforms to the ALDT framework arising from the BOT review. Accordingly, Part 8, Item 55 should be amended to apply to assessments starting on or after 1 July 2015, or sooner if the BOT can recommend and laws can be implemented on ALDT before then.

Transitional provisions

A new transitional regime should be included in the ED which provides for a 'grandfathering' of existing investments.

AVCAL believes that this can be achieved through the following mechanism whereby the existing thin capitalisation safe harbour threshold (i.e. 75% for general investors) applies on a proportionate basis to all debt capital issued on or before the commencement date (e.g. 1 July 2015).

This mechanism could involve a calculation of a "safe harbour debt amount" that utilises the current thresholds (i.e. 75% for general investors and 20:1 for financial investors) for that proportion of the entity's debt capital which was issued prior to the commencement date of the reforms (e.g. 1 July 2015).

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[1] The Hon. Joe Hockey MP speech, "A Coalition Government's Approach on Tax", 23 Nov 2012; Media Release by Senator Mathias Cormann, "Labor's retrospective tax grabs raise sovereign risk threat", 16 Mar 2012.

This could be effected via minor amendments to the definition of "adjusted average debt" and the calculation of the "safe harbour debt amount" in all relevant circumstances (i.e. inward and outward investors, general and financial).

In particular, the grandfathering mechanism could be effected broadly as follows:

- The "adjusted average debt" calculations in section 820-85(3) (for outward investors) and section 820-185(3) (for inward investors) would be updated to separately capture the average value of debt interests issued prior to 1 July 2015 ("Grandfathered Adjusted Average Debt") and debt interests issued after 1 July 2015 ("New Adjusted Average Debt").

- An initial safe harbour debt amount calculation would be undertaken under the existing safe harbour debt thresholds ("Current Safe Harbour Debt Amount").

- A safe harbour debt amount calculation would also be undertaken under the proposed safe harbour debt thresholds ("New Safe Harbour Debt Amount").

- The actual safe harbour debt amount used for the purposes of determining the amount of excess debt ("Transitional Safe Harbour Debt Amount") would be calculated as a proportion of the Current Safe Harbour Debt Amount which relates to the Grandfathered Debt, plus the proportion of the New Safe harbour Debt Amount which relates to the New Debt.

An example calculation under the proposed grandfathering transitional mechanism using an inward investment vehicle (general) and the method statement table in section 820-195 by way of example would be as follows:

	Current Regime	Proposed Reforms	*Ref*	Grandfathering Mechanism	*Ref*
Step 4 – s. 820-195	100	100	*A*	100	*H*
Step 5 – s. 820-195	75%	60%	*B*	*n/a*	*I*
Current Safe Harbour Debt Amount	75		*C1=B*A*		
New Safe Harbour Debt Amount		60	*C2=B*A*		
Transitional Safe Harbour Debt Amount				73	*J = (K/M)*C1 + (L/M)*C2*
Grandfathered Adjusted Average Debt	65	65	*D*	65	*K*
New Adjusted Average Debt	n/a	n/a	*E*	10	*L*
Total Adjusted Average Debt	65	65	*F = D+E*	75	*M = K+L*
Excess Debt	n/a	5	*G=C-A*	2	*N = M-J*

Summary

For the reasons outlined in this letter, AVCAL is of the view that Treasury should recommend to the Government that there be a deferral of start date of the ED to align with the enactment of any rule changes arising from the ALDT review (or until Government confirmation that no changes will arise from the ALDT review). Further, AVCAL is of the view that Treasury should introduce grandfathering provisions into the thin capitalisation ED.

If you would like to discuss any aspect of this submission further, please do not hesitate to contact me or Dr Kar Mei Tang on 02 8243 7000.

Yours sincerely,

Yasser El-Ansary
Chief Executive
AVCAL