AUSTRALIA'S THIN CAPITALISATION REGIME: OECD COMPLIANCE, POLICY ISSUES AND AN INTERNATIONAL COMPARISON

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A nation's thin capitalisation laws are an important instrument for preventing revenue loss resulting from excessive allocation of debt to resident operations. These laws can also act as a tool for regulating the structures and processes of entities within a nation's borders. The principal purpose of this paper is to establish the merits of Australia's thin capitalisation laws based on three criteria: the extent to which they comply with OECD guidelines; the extent to which they reflect the policy behind their enactment; and their strength relative to the thin capitalisation regimes of fellow OECD member countries. The paper will also provide comment on the recent proposals to reform the thin capitalisation regime following the 2013-14 Federal Budget release.

1. INTRODUCTION

Thin capitalisation can be described as the use of excess debt over equity capital in financing an entity.[1] The tax advantage to be gained in thinly capitalising any cross-border investment derives primarily from the tax-deductible nature of interest, as well as the generally lower withholding tax rate that interest leaving a country attracts; compared to (non-deductible) dividends being paid cross border.[2] While it is well accepted

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[1] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), 4.

[2] Roy Rohatgi, *International Taxation Volume 2: Practice* (BNA International, Milbank London, 2nd ed, 2007) 214.

that an entity may be financed with equity or debt/loan capital, where loan capital is excessive, this will minimise the tax collected by the country in which the entity operates. In Australia, there are thin capitalisation laws in place to prevent tax minimisation through excessive allocation of debt to resident operations by multinational entities.[3]

Australia's current thin capitalisation regime was enacted in 2001, with the aim of improving the integrity and fairness of Australia's income tax law.[4] It was predicted that by 2005, a revenue gain of AUD 350 million would be recognised as a result of the thin capitalisation rules enacted in 2001.[5] It is, therefore, paramount that Australia's thin capitalisation regime operates in accordance with its intended policy. Following recent research by the Organisation for Economic Cooperation and Development (OECD) into base-erosion and profit-shifting (BEPS)[6] the 2013-14 Commonwealth Budget, in conjunction with a proposal paper by the Commonwealth Treasury,[7] has highlighted a number of intended changes to the current thin capitalisation regime. Furthermore, while the policy behind the 2001 laws broadly aligns with the OECD's guidelines, the legislation enacted fails in giving effect to some of the policy considerations on which it was founded.

Section 2 of this paper provides a brief summary of the operation of Australia's thin capitalisation regime. Following this, Section 3 gives an overview of the historical development leading to Australia's current thin capitalisation regime, as well as an analysis of remaining internal issues within the current

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[3] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [1.6].
[4] Ibid 2.
[5] Ibid.
[6] Organisation for Economic Cooperation and Development (OECD), *Addressing Base Erosion and Profit Shifting*, 2013, OECD publishing.
[7] Commonwealth Treasury, 'Addressing Profit Shifting through the Artificial Loading of Debt in Australia' (Proposal Paper 14 May 2013).

system. Section 4 discusses the proposed reforms to the current thin capitalisation provisions within the backdrop of growing concern in relation to BEPS. This is followed in Section 5 by an examination of the extent to which Australia's thin capitalisation laws comply with international OECD guidelines. Continuing with the theme of international standards, in Section 6 this paper then explores the strength of Australia's thin capitalisation laws on a comparative international basis. Finally Section 7 provides concluding remarks including an overview of the issues that will remain after the proposed reforms are implemented.

2. AUSTRALIA'S THIN CAPITALISATION LAWS

Australia's thin capitalisation rules apply to both Australian entities operating internationally ('outward entities'),[8] to foreign controlled Australian entities, and to foreign entities that operate in Australia ('inward entities').[9] For the purpose of these rules, 'entity' may mean any of the following: individual; a body corporate; a body politic; a partnership; any other unincorporated association or body of persons; a trust; a superannuation fund; or an approved deposit fund.[10] The thin capitalisation rules do not apply where an entity claims no debt-related deductions (such as interest expenses), or where these expenses (for the entity or any of its associates) do not exceed AUD 250,000 in an income year.[11] In addition, the rules do not apply to certain bona fide securitisation vehicles.[12] Furthermore, the rules do not apply to an outward entity that is not also an inward entity where that entity's Australian assets (including that of associates), divided by its foreign assets (including those

[8] *Income Tax Assessment Act* 1997 (Cth) (ITAA 1997) sub-div 820-B.
[9] Ibid sub-div 820-C.
[10] Ibid s 960-100(1).
[11] The de-minimis exception; ibid s 820-35.
[12] For a discussion see; Trent Henry, Angelo Nikolakakis and Darrell Bontes, 'Thin Capitalisation Regimes in Selected Countries' (2008) *Ernst & Young LLP* 1, 2; ibid s 820-39.

of associates), are equal to or greater than 0.9.[13] There is also an exemption where an asset or non-debt liability is used wholly or principally for private or domestic purposes.[14] Debt-deductions for the purpose of the rules include interest and other costs incurred by an entity in relation to debt interests issued to the entity.[15] The rules apply to a consolidated group as if it were a single entity.[16]

If an entity is subject to the thin capitalisation rules, it must calculate its 'adjusted average debt' and compare this to its 'maximum allowable debt', and where the adjusted average debt is the greater amount, a proportion of the excess will be denied a deduction.[17] For the purpose of assessing maximum allowable debt, outward entities[18] have the ability to apply the safe-harbour debt test,[19] the arm's length debt test,[20] or the worldwide gearing test.[21] Inward entities may only apply the safe-harbour debt test,[22] or the arm's length debt test.[23]

2.1 Treatment of Disallowed Interest

Where adjusted average debt exceeds maximum allowable debt a proportion of the excess is disallowed: that proportion being the sum of the excess divided by average debt held by an entity, multiplied by all the debt deductions made by that entity for that year.[24] The effect of this is to disallow debt deductions in direct proportion to the amount by which adjusted average

[13] ITAA 1997 s 820-37(1).
[14] Ibid s 820-32.
[15] Ibid s 820-40.
[16] Ibid s 820-581.
[17] Ibid s 820-115, s 820-220.
[18] The distinction between outward and inward entities will be described briefly in Section 4.
[19] ITAA 1997 s 820-90, s 820-95.
[20] Ibid s 820-105.
[21] Ibid s 820-110.
[22] Ibid s 820-190,s 820-195.
[23] Ibid s 820-215.
[24] Ibid s 820-115, s 820-220.

debt exceeds maximum allowable debt. [25] The formula is intended to be applied to each debt deduction separately, allowing for difference in tax rates for certain 'pools' of profits.[26] However, in application most entities will apply the formula to their total debt deduction for the income year.[27] Interest expenses that have been denied remain subject to withholding tax,[28] but will not be re-classified as dividends. The result in denying debt deductions to an entity are an increase in taxable income for that entity, and therefore an increase in tax revenue collected by the Australian Taxation Office.[29]

Although this paper, for the most part, does not analyse Australia's thin capitalisation laws in relation to Authorised Deposit-Taking Institutions (ADI), or inward/outward financial entities, it is worth noting their alternate treatment by law. Given the nature of ADIs and financial entities, they are generally permitted larger debt funding levels.[30] Financial entities, as defined by the relevant provisions,[31] commonly require larger debt funding levels to support their lending and securities

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[25] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [2.107].

[26] For example, if an entity has five separate debt deductions for a year of AUD 100,000 each (average debt is therefore AUD 500,000), and if this is in excess of maximum allowable debt by AUD 200,000 it has two options. It can calculate the amount of debt disallowed in five separate transactions for each of its five separate debt deductions, which would equal five separate amounts of AUD 40,000 of debt being disallowed, totalling AUD 200,000. Another option would be to aggregate the five separate debt deductions before applying the formula which would also yield a disallowed interest amount of AUD 200,000.

[27] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [2.108].

[28] Ibid [1.15].

[29] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), 4.

[30] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth) [2.10], [4.1],[5.1].

[31] ITAA 1997 s 995-1(1) Schedule 2 Item 31; s 820-100; s 820-200; s820-210.

business.[32] For financial entities, the thin capitalisation rules operate similarly to that of general entities as discussed above,[33] however a larger safe harbour debt level of 20:1 is permitted.[34] ADIs, as defined by the *Banking Act 1959* (Cth), are generally required to have a *safe harbour capital amount of* equity capital of at least 4% of its risk-weighted Australian assets.[35] This requirement is aimed to mimic the capital adequacy requirements generally prescribed to banks by regulators such as the Australian Prudential Regulation Authority (APRA),[36] while still allowing for competitiveness in the market.[37]

3. Historical Development and Policy Issues

Australia's original thin capitalisation rules were enacted in 1987.[38] These rules revolved primarily around the notion of a maximum allowable gearing ratio; a term which is used to describe the debt-to-equity funding ratio of an entity. Gearing ratio is expressed in numerical terms such as 5:1, which would indicate that for each dollar of equity funding an entity is funded by five dollars of debt. An entity that is funded primarily with debt is said to be 'highly geared', and its profits in an income year may be greatly reduced as a result of interest payments on the high level of debt it maintains. If these interest payments are paid offshore, tax revenue will be lost by the country in which the entity resides. Therefore, many nations,[39] including

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[32] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth)[2.10].
[33] ITAA 1997 s 820-100; s 820-200; s 820-210.
[34] Ibid.
[35] Ibid s 820- 310; s 820-405.
[36] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [4.8], [5.9].
[37] Ibid [5.34].
[38] *Income Tax Assessment Act 1936* (Cth) (ITAA 1936), Div 16F.
[39] OECD member nations that include a maximum allowable gearing ratio within their thin capitalisation rules are Canada, France, Japan, Netherlands, New Zealand, United Kingdom, United States, South Korea; see Henry, Nikolakakis and Bontes, above n 12, 50.

Australia, seek to set a maximum allowable gearing ratio for entities operating within their borders. If the allowable gearing ratio set by a country is too low it may limit legitimate trading as well as the potential for international trading activities within that country.[40] However, if the gearing ratio is set too high there may be considerable tax revenue loss. Furthermore, the allowable gearing ratio and thin capitalisation laws of a country can also affect the capital structure and profit shifting methods of multinational entities.[41] It is therefore important that Australia's thin capitalisation laws adhere to policy considerations and reflect the gearing ratio established by these policies.

Under Australia's original thin capitalisation rules an entity's maximum allowable gearing ratio was 2:1.[42] Only amounts of foreign debt and equity were taken into account when applying this ratio, thereby limiting the maximum allowable foreign debt of an entity to twice its foreign equity. As a result of this restricted application, the thin capitalisation rules applied only to inbound investors, and did not affect the debt levels of outbound Australian investors. This ratio restriction consequently applied only to amounts of foreign debt and equity held by an entity[43] and limited the maximum allowable foreign debt of inbound entities to double their foreign equity.[44] The Ralph Report identified overlooking the operations of resident entities and overlooking third party debt as two problems with this limitation. The original rules did not restrict the proportion of third party debt allocated to Australian operations.[45] Third

[40] Ana Douardo and Rita De la Feria, Oxford University Centre For Business Taxation, *Thin Capitalisation Rules in the Context of the CCCTB (Common Consolidated Corporate Tax Base),* Working Paper (WP) Series 08/04, 2.
[41] Ibid 17- 22.
[42] ITAA 1936 s 159GZS.
[43] Ibid s 159GZG.
[44] Ibid s 159GZA.
[45] Review of Business Taxation, *A Tax System Redesigned* (1999) (Ralph Report), 659.

party debt is an obligation by a third party to pay the debt of a debtor rather than the debt owed to the debtor. For example, an offshore entity (entity O) may lend money to an Australian associate (entity A), which under the original thin capitalisation laws, would subject A to the thin capitalisation rules as the debt would be regarded as foreign debt. The Australian entity may however loan a corresponding amount to a third party Australian entity (entity B), requiring them to pay O rather than the A. Entity B would not be subject to the original thin capitalisation laws as the debt would not be regarded as foreign. Thus, while A (having an amount of foreign debt) , may not claim any of its interest expenses associated to any amounts that exceeded the maximum allowable debt under the previous regime, it has passed on these interest expenses and overall payment of the loan to entity B which is not subject to the thin capitalisation rules. Therefore A may operate effectively free from debt as B is obliged to pay entity O, and entity B may continue to claim interest expenses as deductions free from the restrictions of the thin capitalisation regime as it would have applied. In order to solve the third party debt issue it was recommended that outbound investors be subject to the thin capitalisation laws, and that total debt received by an entity be included in calculating its gearing.[46]

Furthermore, as the original rules applied only to non-resident entities, they did not prevent excessive debt allocation flowing to onshore Australian operations through offshore branches of Australian multinationals.[47] To resolve this it was recommended that the Australian thin capitalisation rules should encompass Australian multinationals with offshore investments.[48] In order to accommodate these changes, the 2001 rules increased the maximum allowable debt under the safe-

[46] Ibid 659.
[47] Ibid 664-665.
[48] Ibid.

harbour debt test to a ratio of 3:1.[49] However, this increase was accompanied by a new method of calculation. Rather than simply multiplying all of the equity of an entity by three to reach a ratio of 3:1, the new rules broadly required the multiplication of all assets of an entity by 75%:[50] with an essential aspect of this method change being the inclusion of a minimum equity funding rule.

The new formula can be described as an 'asset' based calculation, while the method under the original rules can be described as an 'equity' based calculation. There was no reasoning by the government for the change in methods, however it was assumed by it that in making the change the rules would reflect the policy of a maximum gearing ratio of 3:1.[51] Incorrectly, the Government assumed that the two different methods of calculation would ultimately yield the same results. Assume that a company has a share capital (equity) of AUD 10, and a loan (debt) of AUD 90 reflected by assets of AUD 100. Under an 'equity' based calculation, the maximum gearing ratio of 3:1 would equal three times the equity of that company, or AUD 30. [52] In contrast, under an asset based calculation the maximum gearing ratio of 3:1 would equal 75% of the assets of the company, equalling AUD 75.[53] Furthermore, under an asset based calculation, where the debt of the company is increased and applied to the acquisition of assets, this may increase the maximum allowable debt without any required increase in the equity of the company.[54]

[49] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [1.15], [2.50].
[50] ITAA 1997 (Cth) s 820-95(1).
[51] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [1.15], [2.50]-[2.57].
[52] See Antony Ting, 'Thin Capitalisation: Issue on the "Gearing Ratio"' (2004) 7 *Journal of Australian Taxation* 94, 96.
[53] Ibid.
[54] Continuing from the example given, assume that the company in a following income year increase its loan from AUD 90 to AUD 1,000. This will increase

Although policy behind the legislation requires that an entity maintain a minimum amount of equity funding equal to 25% of its assets,[55] this rule is not reflected in the legislation. As stated above the safe-harbour debt test simply requires an entity to multiply its assets by 75%[56] to reach the maximum allowable debt funding level. Regard is had to the actual level of equity funding of an entity only in calculating total assets, not in directly calculating the maximum allowable gearing ratio. Though the Ralph Report recommended an increase in gearing ratio to 3:1, it did not refer to a change in the method of calculation.[57] The current safe-harbour debt test fails to reflect the policy of a maximum gearing ratio of 3:1, and this in turn highlights an integral issue within Australia's thin capitalisation laws.[58] The clear solution to this problem may be to return to an equity based calculation of the gearing ratio.[59]

4. Proposed Changes to the Current Thin Capitalisation Regime

4.1 BEPS – A Reason for Change

The rules set in place by a country to comply with the OECD's principles against double taxation[60] can lead to the openings needed for multinational entities to put in place tax strategies which are inconsistent with OECD and domestic tax

assets to AUD 1,010 and subsequently increase the maximum allowable debt under an 'asset' based calculation to AUD 757.50. Under an 'equity' based calculation maximum allowable debt would remain at AUD 30. This example was taken from; Ting, above n 52, 96.

[55] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [2.55].

[56] ITAA 1997 s 820-95(1).

[57] Ralph Report, above n 45, 661.

[58] Ting, above n 52, 96.

[59] Ibid.

[60] See, eg, OECD, above n 6, 5; OECD, *Model Tax Convention on Income and on Capital (Condensed Version)*, July 2010; OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 2010.

policies.[61] In 2013, the OECD released a report which charted the growing concern that multinational entities were shifting profits in order to erode their tax bases.[62] This report highlighted that base erosion represented a serious risk to a country's tax revenue and that a significant source of this erosion resulted from profit shifting.[63] Although this recognition is not a novel idea, hence the very existence of Australia's thin capitalisation regime,[64] the OECD infers that BEPS is on the rise and that there is an immediate need to address the issue.[65] Among other areas needing to be addressed are the effectiveness of domestic anti-avoidance measures, in particular a nation's thin capitalisations rules,[66] which were perceived as a potential avenue for BEPS.

The 2013-14 Commonwealth Budget addressed the issue of BEPS, indicating an intention to 'tighten and improve' a number of Australia's international taxation laws.[67] Following the Budget announcement, the Commonwealth Treasury released a proposal that outlined a number of intended legislative changes aimed at strengthening Australian international taxation laws.[68] Among intended changes targeting s 23AJ[69] and s 25-90 of the

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[61] OECD, above n 6, 5.
[62] Ibid 13.
[63] Ibid 5.
[64] See, generally, Ralph Report, above n 45, 661.
[65] OECD, above n 6, 15.
[66] Ibid, 6, 38, 44, 48, 85.
[67] Commonwealth of Australia, 'Budget Measures' (Budget Paper No 2, 14 May 2013), 33.
[68] Commonwealth Treasury, above n 7.
[69] Although not pertaining directly to Australia's thin capitalisation laws, these changes have been mentioned as they form an important aspect of reform to Australia's international taxation laws, targeting a combined loop hole regarding these provisions and the thin capitalisation rules in Div 820 of the ITAA 1997. For a discussion on this, see Commonwealth Treasury, above n 7, [3.4]. However, also note a consecutive media release by the Coalition Government, which has indicated that the current Government will not proceed with the changes to s 25-90 as they intend to enact specific anti-avoidance provisions to address this issue; see Commonwealth Treasurer and Assistant

ITAA 1997, there were also a number of proposed changes to the thin capitalisation regime, including:[70]

- a reduction in the safe-harbour debt test from a ratio of 3:1 to 1.5:1 on a debt to equity basis, or a maximum debt gearing of 60 per cent of total assets;
- a decrease in the worldwide gearing ratio from 120 per cent to a 100 per cent, and an extension of the applicability of this test to inbound investors;
- an increase in the safe-harbour capital limit from 4 per cent to 6 per cent (of the risk weighted assets of Australian operations for banks);[71]
- a reduction in the safe-harbour debt limit from 20:1 to 15:1 for non-bank financial entities;[72]
- an intention to seek improvements to the arm's length debt test;[73]
- an increase in the *de minimis* threshold from AUD 250,000 to AUD 2 million.

Overall, the Treasury's proposed changes would have a minimal aspect to the operational/procedural aspects of Australia's thin capitalisation regime. Since the enactment of the current thin capitalisation regime, outbound investors have had the ability to apply all three available tests for assessing maximum allowable debt. The proposal would see this ability extended to inbound investors. Apart from the latter, the only considerable operational changes that will not be discussed in this section are the changes concerning financial institution and, authorised deposit taking institutions (banks). The changes

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Treasurer, 'Restoring integrity in the Australian Tax System' (Media Release, 6 November 2013).

[70] Commonwealth Treasury, above n 7, [27].

[71] These changes will not be discussed in any depth within this paper. These changes have been proposed in order to bring the thin capitalisation rules into line with Basel III standards; ibid [17].

[72] Ibid.

[73] This will be discussed in Section 5 of this paper.

proposed to the *de minimis* rule are aimed to decrease compliance costs and, to ensure that small business do not fall under the thin capitalisation regime.[74]

4.2 Worldwide Gearing Test

The current worldwide gearing test is available only to outward entities. An outward entity is an Australian entity which; is the controller of at least one 'Australian controlled foreign entity'; or which carries on a business at (or through) a permanent establishment abroad; or is an associate of either of these entities.[75] Australian controlled foreign entities are made up of: 'controlled foreign companies' (CFC);[76] 'controlled foreign trusts' (CFT);[77] and 'controlled foreign corporate limited partnerships' (CFCLP)[78]. There are separate rules to determine how an entity will be placed within the rules.[79] An Australian entity is the controller of a CFC if it has a TC control interest of at least 10 per cent, or, if it has a TC control interest of at least 1 per cent and 5 or fewer Australian entities control that CFC.[80] TC control interest in a company is defined in s 820-855 ITAA97. The existing 'worldwide gearing test' may allow for an outward entity, which is not also an inward entity, to have a higher gearing ratio than that prescribed under the safe-harbour debt test.[81] While the safe-harbour debt test allows for a maximum debt amount of 75 per cent of the assets of an entity,

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[74] Commonwealth Treasury, above n 7, [28].
[75] ITAA 1997 s 820-85(2); for the purpose of the thin capitalisation rules, entities are associated where one entity holds an 'associate interest' in another entity of 50% or more, or where the first entity can oblige the other entity to act in accordance with its direction in relation to the distribution of its profits or its financial policy; s 820-905(1).
[76] Ibid s 820-785(1).
[77] Ibid s 820-790 (1).
[78] Ibid s 820-795(1).
[79] Ibid ss 820-780 to 820-795.
[80] Ibid s 820-750.
[81] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [3.62].

the worldwide gearing test allows for a gearing of 120 per cent of an Australian entity's worldwide gearing ratio.[82] The policy intention behind permitting an increased gearing ratio for outward entities is to allow increased borrowing for Australian entities investing offshore.[83] However, this policy may become weakened by the proposed changes.

The Treasury proposes a reduction in the worldwide gearing ratio from 120 per cent to 100 per cent, a measure which is aimed to balance the gearing of Australian entities with that of their global group.[84] It is claimed that this will prevent debt being artificially loaded into Australian entities at levels above the global gearing of the multinational group, therefore preventing debt being artificially loaded into Australia.[85] This claim has some merit as the proposed change would reduce the amount of debt being loaded into Australia through the domestic operations of outbound investors, therefore reducing overall debt deductions claimed in Australia under the worldwide gearing test. Consequently, this may raise the overall taxable income for Australian outbound investors, increasing tax revenue.[86] However, as a result, this may provide less incentive for Australian entities to invest offshore, thus diminishing a policy consideration of the current worldwide gearing test. Whether a change in the worldwide gearing ratio will achieve equilibrium between protection of tax revenue and encouragement of offshore investment is a matter which merits further investigation.

The Treasury proposal also indicated an intention to provide a further 'safe-harbour test' for inbound entities, extending to

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[82] ITAA 1997 s 820-110(2).

[83] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [3.61]; Ralph Report, above n 45, 665.

[84] Commonwealth Treasury, above n 7, [17].

[85] Ibid.

[86] See, generally, ibid.

them the option of applying a worldwide gearing test.[87] A foreign entity that operates at or through a permanent establishment in Australia, as well as a foreign controlled Australian entity may be classed as an inward entity for the purpose of the rules.[88] There are a number of flow-on effects caused be the proposed extension of the worldwide gearing test. Firstly, there may be an increase in investments in Australian operations by offshore multinationals. Allowing offshore investors to use a worldwide gearing test (or a safe-harbour debt level equal to that of their global gearing ratio) could result in an increase in allowable debt deductions for the Australian operations of multinational entities. This would reduce the tax payable in Australia, making investment more desirable. Conversely, a clear issue with this scenario is that an increase in allowable debt deductions in Australia may result in a decrease in taxable income which, in turn, may reduce tax revenue collected in Australia. A balance must be struck between the protection of collectable tax revenue and the encouragement of offshore investment into Australia. Given this, a gearing ratio of 100 per cent may be logical. A worldwide gearing ratio of over 100 per cent may entice offshore investors to load their debt artificially into their Australian operations where a gearing ratio higher than that of the global group's level would be allowable. By reducing the ratio to 100 per cent, and ensuring that the gearing ratio within Australia is equal to that of the global groups, an extension of the worldwide gearing test becomes plausible. However, in order for the worldwide gearing test to become applicable to inbound investors more research into possible modifications to the test may be required.[89]

[87] Ibid [30].
[88] ITAA 1997 s 820-185(2).
[89] Commonwealth Treasury, above n 7, [32].

4.3 A New Safe-harbour Debt Level

The Treasury's proposal paper describes the current safe-harbour debt test as 'generous', highlighting that the 2001 rules allowed a far higher gearing (debt-to-equity) ratio than was common among companies operating as 'truly' independent.[90] The Treasury paper proposed a reduction of the debt-to-equity ratio from 3:1 to 1.5:1, or, 60 per cent of total assets.[91] As a result of this reduction, the allowable debt levels under the safe harbour test may be reduced by up to 20 per cent.[92] The move to reduce the gearing ratio is consistent with the recent Treasury issues paper.[93] This issues paper referred to New Zealand, Germany, Canada, Sweden, Portugal, and Belgium, which had already made moves to tighten their own thin capitalisation laws.[94] It is also supported by recent research conducted by the Reserve Bank of Australia, as well as the Treasury's own research, both showing that a gearing ratio above 60 per cent was uncommon among ASX listed companies.[95] Despite this, the effectiveness of this reduction remains questionable.

Given the examples provided in Section 3, it is clear that an accurate debt-to-equity ratio cannot be achieved through an asset based gearing ratio test. An asset based test seeks to multiply the entire assets of an entity by a percentage, in the

[90] Ibid [12].
[91] Ibid [27].
[92] In a situation where an entity has AUD 100 million of assets, AUD 75 million being debt and AUD 25 million being equity, under the current safe-harbour debt test that entity may claim debt deduction on its entire amount of debt. Given the same structure under the proposed new rules, that same entity may only claim deduction on 60 per cent of its assets, or AUD 60 million; this is a 20 per cent reduction; see Peter Collins, *Tighter Thin Capitalisation Regime to Limit Australian Debt Deduction* (2013) PricewaterhouseCoopers < http://www.pwc.com.au/tax/federal-budget/2013/thin-capitalisation.htm>.
[93] Coommonwealth Treasury, 'Implications of the Modern Global Economy for the Taxation of Multinational Enterprises' (Issues Paper May 2013).
[94] Ibid [84].
[95] Commonwealth Treasury, above n 7, [14].

case of the proposed reform 60 per cent, which should yield a debt-to-equity ratio of 1.5:1. However, as the assets of a company equals the sum of its debt and equity, this will only be the case where an entity is already financed at a ratio of 60 per cent debt and 40 per cent equity. For example, if an entity is funded at AUD 60 million of debt, and AUD 40 million of assets, its assets equal AUD 100 million, and therefore its allowable debt level on an asset based calculation is AUD 60 million; or 1.5:1 of its assets, which equates to a gearing ratio of 1.5:1. If the same entity was restructured, and its debt funding was increased to AUD 100 million, while the equity of the entity remained at AUD 40 million, under an asset based test the entity's allowable debt levels would be 60 per cent of this total (AUD 140 million), or AUD 84 million of debt, while its equity levels remained the same. A solution to this issue may be to include a minimum equity funding rule or, to return the basis for assessing maximum allowable debt to an equity based calculation.[96]

5. AUSTRALIA'S COMPLIANCE WITH OECD GUIDELINES

As each nation can assert their sovereign right to tax residents and non-residents operating within their borders, there is potential for amounts to become taxed on more than one occasion.[97] In order to curb the effects of such double taxation, the OECD has attempted to clarify, standardise and confirm the fiscal situation of entities trading and operating internationally.[98] The OECD's Model Tax Convention (MTC), seeks to provide a means of settling problems that may arise within the sphere of international tax.[99] There are three key areas for any member nation seeking to enforce a thin capitalisation regime but

[96] Ting, above n 52, 96.
[97] See, eg, OECD above n 6, 5.
[98] OECD, *Model Tax Convention*, above n 60.
[99] Ibid 7.

wanting to remain within the ambit of the MTC: the treatment of disallowed interest; unbiased application of the rules; and compliance with the 'arm's length principle'.

5.1 Unbiased Application of the Rules

Prior to 2002 and the decision of *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*,[100] many countries, including Australia with its former thin capitalisation regime, applied their thin capitalisation rules only to non-residents.[101] This is in line with the rationale behind these regimes, which primarily seek to prevent the leaking of tax revenue offshore through excessive debt funding of domestic entities by offshore parent companies operating in tax havens.[102] However, such a narrow application can yield a number of anomalies. First of all, it does not prevent excessive injection of debt into resident entities by multinational resident entities. Furthermore, the bias inherent in such a narrow application of thin capitalisation laws is in violation of the OECD MTC, as well as a ruling by the European Court of Justice (ECJ).[103]

Article 24 of the MTC seeks to prevent tax discrimination based on nationality.[104] While the article does not prohibit an OECD member country from applying thin capitalisation rules,[105] it forbids a disparity between the treatment of domestic entities and foreign entities for tax liability purposes.[106] The Article requires that the operations of foreign permanent establishments within a country be subject to the same progressive levels of taxation as a resident entity.[107] The

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[100] (324/00) [2002] EJC 1.
[101] Douardo and De la Feria, above n 40, 6.
[102] Rohatgi, above n 2, 215-216.
[103] *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* (324/00) [2002] EJC 1.
[104] OECD, *Model Tax Convention on Income and on Capital (Condensed Version)*, July 2010, 334.
[105] Ibid 352.
[106] Ibid 334-355.
[107] Ibid 348.

Australian thin capitalisation rules apply similarly to both foreign controlled Australian entities (inbound) and to Australian domestic entities that operate abroad or maintain controlled foreign entities (outbound). Similar restrictions are placed on resident and non-resident entities, and therefore the Australian thin capitalisation rules comply with Article 24 of the MTC.

5.2 The Treatment of Interest Costs

There are two approaches available in treating disallowed interest expenses and the debt capital to which they are connected to, and they are not mutually exclusive. A "primary adjustment" can be made to deny excess interest as a deduction, and/or "secondary adjustments" may be made to treat the denied excess as a dividend, and/or treat the connected loan as equity capital.[108] Primary adjustments are a simplified method of tackling tax minimisation schemes, and will ultimately result in an increase in taxable income for the borrower.[109] Nevertheless, primary adjustments may raise issues of double taxation as an increase in the taxable income of the borrower may not be reflected in adjustments to the lender.

Double taxation may occur, where thin capitalisation rules in Australia are applied to deny an amount of interest to an Australian entity, thus increasing its taxable income. Where these amounts of interest have already been paid to an offshore lender they may also be taxed in that country as profits flowing into an offshore entity. If, for example, Australia and an offshore country both applied a tax rate of 30% to company profits, a payment of AUD 10,000 interest to an associated lender by an Australian entity would subject the offshore associate to a tax liability of AUD 3,000 in the offshore country (less any withholding tax credits). If AUD 5,000 of that interest

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[108] Rohatgi, above n 2, 221-222.

[109] As reflected in the operation of the Australian thin capitalisation regime as listed above.

payment were denied as a deduction to the Australian entity, then it would be liable in Australia to AUD 1,500 of extra tax on the AUD 5,000; which as a result of the denial, would be included in taxable income. The result in this situation is that the original amount of AUD 10,000 has become subject to double taxation, the interest payments have been effectively taxed in the borrowing and lending country. The amount of tax paid on the AUD 10,000 of interest payments is AUD 4,500 rather than AUD 3,000 which does not reflect the company tax rate in either country.

The Australian resident entity in this situation will not be entitled to a foreign income tax offset (FITO), as the foreign income tax (the tax paid for the incoming interest income) has been paid by the *associated offshore lender* to their country of residence; it is not the Australian resident entity paying the foreign tax.[110] For consolidated groups, the thin capitalisation rules apply as if the group were a single entity,[111] and therefore the inability to claim a FITO described above would apply. Furthermore as non-residents can not form part of a consolidated group[112] the scenario above could not occur entirely within the sphere of a single consolidated group. Moreover an Australian FITO in the above scenario will only be available to the offshore lender where the foreign tax (in the residence of the foreign associate or a third country) is imposed on a source rather than a residence basis.[113] Where a country imposes a residency based tax on entities (as in Australia), and this is the foundation for the taxation of the interest payment received by the foreign lender, than a FITO will not be available.[114] Circumstances where a FITO may be available to the lender would be rare, but may involve a form of source-based taxation imposed by the foreign

[110] ITAA 1997 s 770-10(1).
[111] Ibid subdiv 820-FA.
[112] Ibid s 703-15(2).
[113] Ibid 770-10 (3) (a).
[114] Woellner et al, *Australian Taxation Law* (CCH 21st ed 2011), 1483.

country on any interest income. Additionally, for a FITO to be available to the offshore lender, any interest payments must originate outside of its country of residence. [115]

Despite double taxation issues surrounding primary adjustments discussed above, they are allowed for by the OECD, which states that a borrower country retains the right to increase taxable profits of an entity through its thin capitalisation laws without previously creating an obligation in the lender country to make a required adjustment.[116] The OECD does, however, provide a solution to the potential double taxation problem through Article 9(2) of the MTC, which allows for a corresponding adjustment to be made in one of two ways. Firstly, a relief credit may be given by the lender State to the lender for the increased tax paid in the borrower State. Secondly, the taxable profits of the lender may be adjusted downwards to reflect the amount of tax paid in the borrower State. These changes are subject to the primary adjustment adhering to OECD arm's length principles, and being accepted as doing so by the country making the corresponding adjustment.[117] Therefore while Australia's primary adjustment method complies with OECD guidelines, there is no scheme in operation which allows for the alleviation of double taxation where Australia's is the resident country of an offshore lending entity. Discussed below are further opportunities for OECD sanctioned improvements in relation to Australia's treatment of disallowed interest expenses, with regard to the potential implementation of secondary adjustments.

Article 9 of the MTC requires that the thin capitalisation rules of a country should not increase the taxable profits of an entity to more than the profit that the entity would have made if operating within arm's length principles.[118] Once an amount of

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[115] ITAA 1997 770-10(3)(b).
[116] OECD, *Model Tax Convention*, above n 60, 183.
[117] Ibid 184.
[118] Ibid Article 9 [3].

interest (or other debt-deduction) has been denied to an entity, it may be prudent for a nation to apply secondary adjustments as discussed above, in order to return the situation to what would have existed had all transactions been undertaken within arm's length principles.[119] The attribution of excessive interest expenses to an entity is often an attempt by a parent entity (or entity group) to fund an operation largely on debt which requires interest repayments, rather than on equity which requires dividend repayments. As well as the fact that interest payments attract a deduction, dividend repayments are often subject to double taxation and generally attract higher withholding tax rates in comparison to interest repayments. Rather than simply denying excess deductions to a borrowing entity (primary adjustments), secondary adjustments aim to attach to the denied excess deduction the label of capital, so as to reflect that excess amounts of debt and their connected interest repayments are in fact attempts to mask capital funding and connected dividend payments. Secondary adjustments may therefore serve two purposes within a thin capitalisation regime. Firstly, they may further align a regime with the arm's length requirements of Article 9, through recognition that excessive debt funding would have, in fact, been capital funding if arm's length principles had been adhered to from the outset of the entity's funding scheme. Secondly, where prescribed debt funding levels are exceeded, secondary adjustments, if implemented correctly, may adjust the tax revenues collected within a nation to the amounts that would have been received had the debt to equity funding levels been within prescribed limits.

The results of secondary adjustments resonate through both borrowing and lending entities because the outflowing payments of 'interest' are now taxed at the rate set for dividends in the borrowing country for withholding tax purposes, while being included in the taxable profits of the lending entity as interest.[120]

[119] Rohatgi, above n 2, 222.
[120] Ibid 329.

To a borrowing entity this would mean an increase in taxable profits due to the loss of the interest deduction, as well as a possible increase in its withholding tax liability as a result of the denied excess being treated as a dividend rather than interest for withholding tax purposes.[121] The result to the lending entity may be a loss of inflowing income due to the increased withholding tax rate paid in the borrowing State on incoming interest payments; which have been redefined as constructive dividends. Also, if the resident State of the lending entity recognises the redefinition of interest income by the State of the borrowing entity, the lending entity must treat any receipts as dividends rather than interest income for all business and tax purposes. Secondary adjustments are not prohibited by the OECD MTC, but are discussed in the commentary on Articles 10,[122] 11[123] and 23.[124]

Where an associated lender shares in the risk of the loan as defined in Article 10,[125] the borrowing State is permitted to redefine amounts of interest as dividends under the OECD MTC,[126] thus effectively allowing for secondary adjustments in certain situations. No rationale is given by the OECD for allowing secondary adjustments in risk sharing situations, however, it appears that the ability to do so stems from the inherent right of a country to determine the meaning of the word 'dividend'. As the OECD has been unable to define the term exhaustively, it allows for the treatment of certain sums as dividends, based on notions adopted from the majority of member countries, or from bilateral agreements between two

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[121] ITAA 1936 s 128B.
[122] OECD, *Model Tax Convention*, above n 60, 191-193.
[123] Ibid 214-220.
[124] Ibid 329; These articles allow for disallowed interest to be treated as dividends and the connected loan as capital, provided that the value of such a loan is treated as capital as it is understood in company law; See, eg, Rohatgi, above n 2, 222.
[125] OECD, *Model Tax Convention*, above n 60, 193.
[126] Ibid 329.

countries.[127] Whether a lender shares in the risks run by the operations of the borrower is a matter to be determined separately in each individual case.[128] Among other considerations, indications of risk sharing may include circumstances where the lender will share in the profits of the borrower, where the loan greatly outweighs any other capital of the borrower company, where interest payments on the loan are subject to the profits of the borrower, or where the loan contains no set parameters for repayment by a specific date.[129] If these circumstances are satisfied, and secondary adjustments have been applied in the borrowing entity's country of residence, then the country in which the lender resides may be obliged by the MTC to give relief to the lender for the economic double taxation flowing from the secondary adjustment. This is provided that the lender country agrees with the reclassification and the amounts reclassified.[130]

Taking into consideration OECD guidelines and potential benefits, secondary adjustments may therefore be added to the Australian thin capitalisation rules in three circumstances. Firstly, secondary adjustments may be made where Australia is the resident country of a borrowing entity and the revenue authority has enough information to determine that the offshore lender shares in the risk as defined by Article 10.[131] This will allow amounts of interest leaving the country to be redefined as dividends for withholding tax purposes in Australia.[132]

[127] Ibid Article 10 [23].
[128] Ibid 193-194.
[129] Ibid.
[130] The lender country would be obliged to agree with the re-classification where it applies similar thin capitalisation rules as the borrower's country of residence, or where the re-classification was within the ambit of Articles 9, 10, 11 and 23; ibid.
[131] Ibid 191-193.
[132] This may in fact increase tax revenue collected in Australia as the current rate of withholding tax on dividends is higher than that of interest; ITAA 1936 s 128B.

Secondly, where an Australian lender shares in the risks run by a related offshore borrowing entity, corresponding secondary adjustments should be made if the debt funding is in excess of prescribed limits in the borrowing country, and that country's thin capitalisation laws have already redefined excessive outflowing interest amounts as constructive dividends. This will allow for inflowing interest to be redefined as dividends received by Australian lending entities, and create a parallel between the tax treatment of such amounts between each country. Finally, in accordance with Articles 9, 10, 11 and 23 as described above, a scheme for alleviating any potential effects of double taxation flowing from secondary adjustments made in other countries should be adopted in Australia. These changes will result in, and allow for, a symbiotic arrangement between Australia and OECD member countries. As well as investigating any further economic consequences, the addition of any form of secondary adjustment into the Australian thin capitalisation rules should be drafted so as to comply completely with the relevant articles of the OECD MTC.[133]

5.3 The Arm's Length Debt Test

Article 9 of the OECD MTC prohibits the thin capitalisation rules of a country from increasing the taxable profits of an entity to more than the arm's length profit that an entity would have made in an income year. An OECD member country seeking to comply with this article would therefore need to include in its thin capitalisation rules a test for allowable debt funding based on arm's length principles.[134] Given that there is an option in Australia for entities to calculate maximum allowable debt based on an arm's length debt test, it would appear that the OECD guidelines are complied with in this respect. However, Australia's current thin capitalisation regime was enacted in

[133] OECD, *Model Tax Convention*, above n 60, Article 9 [3]; Article 10 [15], [25]; Article 11 [19], [35]; Article 23 [67], [68]; Article 24 [55]-[58]; Article 25 [8].
[134] See, eg, Rohatgi, above n 2, 222; ibid Article 9 [3].

2001, and the most recent ruling in relation to the arm's length debt test in this regime was given in 2003.[135] Given that there has been a recent change in the method by which arm's length amounts are determined by the OECD,[136] there may be an opportunity to reform Australian arm's length debt test in order to align it further with OECD guidelines.

TR 2003/1 acts as a guideline for entities seeking to apply the arm's length debt test, by providing a step by step explanation of its operation.[137] It is a six step process,[138] which postulates a notional amount of maximum debt that an entity operating independently would maintain. For the purpose of the test, an entity's Australian operations are considered in isolation from any offshore associates, parents or subsidiaries.[139] The operations of an entity must further be limited to its Australian business, with reference to the assets and cash flows derived from that business.[140] In applying parameters to the arm's length debt test, TR 2003/1 was purported to act in line with the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995 ('1995 Guidelines').[141]

Since 1995, the OECD has released further guidelines in relation to transfer pricing, the most current being in 2010 ('2010 Guidelines'). The 2010 Guidelines specifically exclude application to excessive debt funding situations,[142] as subsequent guidelines on the determination of arm's length amounts within

[135] Australian Taxation Office, *Income Tax: Thin Capitalisation—Applying the Arm's Length Debt Test*, TR 2003/1, 5 March 2003.
[136] OECD, *Transfer Pricing Guidelines*, above n 60.
[137] TR 2003/1, [7]-[8], [22].
[138] Ibid 1.
[139] Ibid [17].
[140] Explanatory Memorandum, New Business Tax System (Thin Capitalisation) Bill 2001 (Cth), [10.10].
[141] TR 2003/1, [8].
[142] OECD, *Transfer Pricing Guidelines*, above n 60, [4.95].

the sphere of thin capitalisation are intended to be released.[143] However given that the Commissioner has previously applied the 1995 Guidelines to the Australian thin capitalisation rules,[144] it is difficult to comprehend why the 2010 Guidelines should not at least be considered. Furthermore, it cannot be accepted that Article 9 as discussed above would require anything but an application of current rather than out-dated OECD arm's length principles.[145] Given that there has been a considerable shift in the approach taken in determining arm's length amounts in the 2010 Guidelines, there may be opportunity for an update of the current arm's length debt test.

The 2010 Guidelines approach the concept of a single entity or permanent establishment in a new manner. In line with the 'relevant business activity approach' approach of the current transfer pricing rules in Australia, previous OECD material postulated that in deriving arm's length amounts, each separate part or permanent establishment of an entity was assumed to be a distinct and separate entity.[146] Such an approach necessarily excluded from the operations of an entity any notional amounts of income or expenses flowing from intra-entity dealings; because, as a rule of law, an entity cannot transact with itself.[147] Therefore, for transfer pricing and thin capitalisation purposes, profits and expenses flowing from intra-entity dealings would not be reflected in assessable income or allowable deductions of an entity.[148] As discussed below, these restrictions are reflected in the Australian thin capitalisation laws through the current arm's length debt test; which excludes profits and expenses flowing from intra-entity transactions entirely from

[143] Ibid 24.
[144] TR 2003/1, [8].
[145] OECD, *Model Tax Convention*, above n 60, 183.
[146] OECD, *Transfer Pricing Guidelines*, above n 60, Article 7.
[147] Commonwealth Treasury, *Income Tax: Cross Border Profit Allocation: Review of Transfer Pricing Rules*, Consultation Paper, 1 November 2011, [61].
[148] Ibid; TR 2003/1, [51]-[70].

consideration when determining an entity's appropriate debt funding levels.

In contrast to previous OECD material, the 2010 Guidelines have moved from a 'relevant business activity approach' approach to a 'functionally separate entity approach'. This new approach still treats an entity as legally separated from any associates, but it allows for certain recognised intra-entity dealings to be taken into account in determining effective profit/loss in an income year. If adopted for thin capitalisation purposes, the 2010 Guidelines should allow only intra-entity dealings to be taken into account where they comply with certain principles.[149] Broadly, dealings with related entities will only be recognised where they have been documented, and where the documents show that the intra-entity dealings would have been adopted by comparable entities operating with commercial rationality.[150] In order to achieve this recognition, the operations of the entity must be analysed in order to assess the functions it performs within the group, the risk assumed, the capital contributed and the assets owned.[151] Also, all dealings with related entities must be priced in accordance with OECD guidelines.[152] As a consequence of this approach, the profits of the functionally separate entity will still reflect its own activities separate to that of the entire entity,[153] however, its operations for thin capitalisation purposes will include any acceptably priced intra-entity dealings.[154] Consequently, a functionally separate entity approach within the current arm's length debt test may yield great differences in maximum allowable debt amounts for entities.

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[149] OECD, *Transfer Pricing Guidelines*, above n 60, 136-145.
[150] OECD, *Model Tax Convention*, above n 60, 139.
[151] Ibid 136-139.
[152] Ibid 137.
[153] Ibid 136-139.
[154] Ibid 138.

The current arm's length debt test takes into account the profits and cash flow of an entity in the second step of a six stage process for determining maximum allowable debt.[155] For the purpose of calculating the cash flow and profits of an entity, regard may not be given to profits or expenses flowing from offshore intra-entity dealings. [156] Furthermore, it appears that in the remaining steps of the six stage process there is no scope for inclusion of profits or losses flowing from offshore related party dealings. However, if a substantial part of an entity's operations in an income year consist of offshore intra-entity dealings and transactions, these transactions may increase the cash flows and profits of the entity for the purpose of the second step of the arm's length debt test. These transactions may also affect other stages of the six stage process, which may in turn be reflected by an increase or decrease in the maximum allowable debt for an entity.

As well as increasing the maximum allowable debt of an entity, the inclusion of related party dealings in arm's length calculations would better reflect the realities of international trading between multinational enterprises,[157] and would also align with OECD policy which states that commercial realities may be reflected in related party dealings. OECD principles recognise that related party dealings may be taken into account in determining an entity's profit or loss despite the fact that they are not always affected by external market forces.[158] The recognition of intra-entity dealings in determining the appropriate debt funding levels of an entity would further align the current arm's length debt test with Article 9 of the MTC, and with the 2010 Guidelines. Despite the fact that the 2010 Guidelines specifically exclude their application to excessive

[155] TR 2003/1, 1.
[156] Ibid [51]-[70].
[157] For a brief discussion on the role of multinational enterprises in world trade, see OECD, *Transfer Pricing Guidelines*, above n 60, 19.
[158] See ibid [1.2].

debt funding situations (thin capitalisation situations), movement to update Australia's arm's length debt test as discussed above may pre-empt future releases of OECD guidelines on the issue. It also appears that for transfer pricing purposes, the Australian Government is re-considering its approach to permanent establishments in order to make changes as discussed above, in an attempt to align further the transfer pricing rules with OECD guidelines.[159] Additionally, it appears that the Australian Government is prepared to align its revised transfer pricing laws entirely with OECD principles,[160] a goal which should also be considered for Australia's thin capitalisation laws. The Australian government has also shown an intention to revise and update the arm's length debt test,[161] but further information on the intended scope of these changes is yet to be released.

6. COMPARATIVE ANALYSIS OF APPROACHES TO THIN CAPITALISATION

The OECD member nations apply a broad range of methods for regulating the allowable level of debt funding for entities operating within their borders. Generally a nation will fall into one of three categories: (i) those which apply no thin capitalisation rules; (ii) those which apply non-specific thin capitalisation rules within the expansive framework of general anti-avoidance rules, and (iii) those that apply specific thin capitalisation rules.[162] Those which apply specific rules commonly adopt an arm's length approach and/or, a fixed debt-

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159 Fiona Craig and Paul Riley, *CCH Australian Tax Week* (12th April 2012) [267].

160 Tax law Amendment (Cross-Border Transfer Pricing) Bill (No1) 2012 (Cth).

161 Commonwealth Treasury, above n 7, [29]; Assistant Treasurer (Cth), 'Board of Taxation Reviews of the Thin Capitalisation Arm's Length Test and Australia's Debt and Equity Tax Rules' (Media Release, 101, 4 June 2013).

162 Douardo and De la Feria, above n 40, 2.

to-equity or debt-to-asset based approach.[163] Also, a relatively new concept among member countries is the adoption of an approach that limits debt funding levels based on the profits of an entity – an earnings limitation approach. In Germany and Italy, an earnings limitation approach broadly prohibits the deduction of interest expense where such expenditure exceeds 30% of an entity's adjusted income.[164] As the ability of an entity to meet its yearly interest expenses has a direct relationship to its profits in that year, the strength of this approach becomes apparent, as the ability of an entity to repay its interest expenses is directly relevant to the amount of income it generates and, therefore, the amount of debt it may maintain under an earnings limitation approach. However, this approach is akin to debt/equity or debt/asset based approaches in that it relies on a pre-set determination of what levels of debt funding are acceptable; these are examples of fixed ratio approaches to thin capitalisation.[165]

Although fixed ratio approaches may allow for some variables based on various conditions,[166] they are generally inflexible in that the fixed ratio offers a maximum safe-harbour amount of debt funding that an entity is permitted to maintain. This inflexibility may lead to the taxable profits of an entity being increased to the point that a nation's thin capitalisation rules are incompatible with OECD guidelines; which state that a member country's thin capitalisation rules cannot increase the profits of an entity to more than the arm's length profit.[167] Furthermore, it appears that OECD members operating within the jurisdiction of the European Court of Justice (EJC) may be

[163] Ibid 4-5.
[164] Henry, Nikolakakis and Bontes, above n 12, 16-20.
[165] Douardo and De la Feria, above n 40, 32.
[166] Conditions can vary in each OECD member country, but may include (for example) whether an entity is an authorised deposit-taking institution (ADI), its operating income, whether it is a resident or non-resident, and any de minimis threshold.
[167] OECD, *Model Tax Convention*, above n 60, 183.

in breach of Article 43 of the European Commission (EC) Treaty if their thin capitalisation rules increase the profits of an entity to more than arm's length amounts.[168] The inflexibility of these approaches can be contrasted with thin capitalisation regimes that measure acceptable debt funding levels based exclusively on arms' length assessments.[169]

The United Kingdom's (UK) thin capitalisation regime has no safe-harbour debt amount based on a fixed ratio approach and instead interest payments to related parties are limited by arm's length principles.[170] Arm's length principles under the regime are based on current OECD guidelines.[171] The UK rules determine both whether the terms of the loan (repayment length/terms, interest rate) are at arm's length, and whether the debt funding level of the entity exceeds arm's length principles.[172] Unlike the scope of most thin capitalisation regimes, which limit only the allowable debt funding levels of an entity, this approach also places limitations on the terms of related party loans. Limitations on terms and interest rates of related party loans are generally issues addressed by the transfer pricing rules within a jurisdiction. In Australia, the transfer pricing provisions are applied to determine whether the debt deductions of an entity, in relation to related party debt, are acceptable according to arm's length principles.[173] In order to determine whether maximum allowable debt has been exceeded, the thin capitalisation regime considers, in combination, related party debt deductions which satisfy transfer pricing rules, as

[168] Douardo and De la Feria, above n 40, 33.
[169] Ibid 32.
[170] Henry, Nikolakakis and Bontes, above n 12, 38.
[171] Certain related party dealings and dealings with subsidiaries may be relevant in determining arm's length amounts; ibid 39.
[172] Ibid.
[173] Australian Tax Office, *Income Tax: The Interaction of Division 820 of the Income Tax Assessment Act 1997 and the Transfer Pricing Provisions*, TR 2010/7, 27th October 2010, [6].

well as all other debt of the entity.[174] Though it is beyond the parameters of this paper to discuss the fusing of thin capitalisation and transfer pricing rules, the UK's current thin capitalisation regime appears to avoid the need to address two separate aspects of the law.

While a fixed ratio approach may limit debt deductions of legitimate related party arrangements where they exceed safe-harbour amounts, a thin capitalisation approach based solely on arm's length determinations may provide more flexibility by allowing for any amount of debt deductions – flowing from related party arrangements or otherwise – provided they are within the limitations of arm's length principles.[175] In the UK, arm's length principles are applied on a case-by-case basis in order to determine whether both the debt funding level of an entity, and the terms/rates of any related party loans are permissible.[176] Furthermore, while the UK rules allow for pre-arrangement schemes to be made where entities agree to remain within certain fixed ratio amounts,[177] the Australian rules currently have no scope for the creation of advance arrangements in this manner. The ability to apply thin capitalisation rules to the circumstances of each individual taxpayer on a flexible basis is advocated by the OECD.[178] Notwithstanding the benefits discussed, there are arguments against a purely arm's length approach to thin capitalisation.

Although being a benefit inherent in a thin capitalisation regime based exclusively on arm's length principles, the allowance of advance arrangements is countered by the fact that, as in the UK, advance arrangements necessarily rely on some form of fixed ratio approach as a foundation. Furthermore, the

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174 Ibid.
175 Douardo and De la Feria, above n 40, 15.
176 Ibid.
177 Trent Henry, Angelo Nikolakakis and Darrell Bontes, above n 12, 39.
178 OECD, *Model Tax Convention*, above n 60, 183; Douardo and De la Feria, above n 40, 15.

flexibility of applying arm's length principles on a case-by-case basis is tempered by the complexity and subjectivity involved in doing so.[179] Determining arm's length amounts often requires specialist knowledge and complex analysis. Furthermore, the broad discretion available to entities when applying arm's length principles from OECD guidelines to their operations makes the approach relatively subjective.[180] The methods available within the OECD's Transfer Pricing guidelines for assessing arm's length amounts are numerous, as are the factors which may be taken into account when applying each method.[181] As well as creating uncertainty for taxpayers, this may generate considerable compliance costs. The UK has acknowledged these issues, which is now considering reviewing its approach to thin capitalisation.[182] Accordingly, it appears that an approach to thin capitalisation based on only arm's length principles is problematic.

In light of the issues surrounding a purely arm's length or fixed ratio approach, a number of OECD member nations,[183] including Australia, apply what may be considered as a hybrid regime. In Australia, an entity is allowed the flexibility of applying arm's length principles in order to determine the level of debt funding it may maintain. However, for entities wanting to avoid the compliance costs and complexities that may be associated with determining arm's lengths amounts, a safe-harbour debt level is provided based on a fixed debt-to-asset ratio approach. This dual approach provides the flexibility of arm's length principles, but mitigates their shortcomings by

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[179] Douardo and De la Feria, above n 40, 15.
[180] Ibid.
[181] The various methods include traditional transaction methods such as, the comparable uncontrolled price methods, the resale price method, and the cost plus method as well as a number of transactional profit methods. For a discussion, see OECD, *Transfer Pricing Guidelines,* above n 60.
[182] Douardo and De la Feria, above n 40, 15.
[183] France, United States, New Zealand; Henry, Nikolakakis and Bontes, above n 12, 39.

providing a fixed safe-harbour amount.[184] A similar hybrid approach was also recommended by the EU for its proposed *Common Consolidated Corporate Tax Base*.[185] A hybrid approach also complies with OECD guidelines and the EC Treaty.[186] Although the Australian hybrid approach to thin capitalisation appears to be the least problematic approach in comparison with international standards, but, as highlighted throughout this paper, aspects of the Australian rules remain flawed.

7. CONCLUSION

The economic effects of thin capitalisation on a nation are numerous. At its simplest level, thin capitalisation may lead to significant loss of revenue within a nation's borders. Moreover, the attempts a country makes to counter this loss may in turn have numerous effects on investment levels, corporate tax rates, tax planning behaviour and capital structures of multinational entities.[187] Consideration has been given to this scope of issues in the Ralph Report, with that Report playing a crucial role in the policy recommendations of the current thin capitalisation laws in Australia. However, legislative rules do not always accurately reflect policy. This is clearly evident in the current asset based safe-harbour debt test, which fails to reflect the recommended gearing ratio of 3:1, a ratio which was said to provide a balance between legitimate trading and protection of revenue. Furthermore, despite the fact that Australia's hybrid regime is the least problematic compared to the regimes of fellow OECD member countries, a number of OECD compliance reforms are needed.

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184 Douardo and De la Feria, above n 40, 15.
185 Ibid.
186 Ibid.
187 For a discussion on how corporate tax rates may be affected by a nation's thin capitalisation laws see ibid 17-22.

Given the multinational nature of most entities affected by a country's thin capitalisation laws, it is vital that Australia's laws are applied in line with international standards. In order to achieve this, Australia's laws must achieve symbiosis with the OECD principles. However, Australia's laws fall short of OECD standards in a number of ways. To start with, Australia's current arm's length debt test is obsolete, as it applies out-dated OECD arm's length principles. However, it is prudent to note that improvements to this test are being sought by the Australian Government, which is currently considering amendments to the arm's length debt test. In addition to this yet to be remedied issue, there is no scope for secondary adjustments in the Australian thin capitalisation rules. Secondary adjustments would serve to further align Australia's thin capitalisation laws with OECD guidelines and principles, and may also aid in achieving parallel between the taxation laws of Australia and fellow OECD member countries. As a final point, there is also currently no scheme in operation which would allow for the alleviation of potential double taxation issues arising from primary adjustments.