

Australian Taxation Office issues final guidance on thin capitalization arm's-length debt test and draft guidance on "outbound" interest-free loans

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Executive summary

On 12 August 2020, the Australian Taxation Office (ATO) released long-awaited debt deduction related guidance. The guidance is comprised of:

- ▶ Final Taxation Ruling [TR 2020/4](#) and Practical Compliance Guideline [PCG 2020/7](#) (replacing the draft PCG 2019/D3) in relation to the application of the arm's-length debt test for thin capitalization purposes
- ▶ Draft Schedule 3 to PCG 2017/4 ([PCG 2017/4DC2](#)) in relation to outbound interest-free loans between related parties

As noted, the guidance has been a long time coming. The ATO has delayed issuing this guidance, and other non-pandemic related guidance, to focus on critical COVID-19 issues. The release of this guidance appears to indicate that the ATO is focusing back on other tax issues held in abeyance due to the pandemic.

Both sets of guidance have been keenly anticipated, with many taxpayers uncertain as to how to treat these issues knowing that ATO guidance was pending. This Alert summarizes some of the key issues and a detailed Tax Alert will be forthcoming.

Detailed discussion

Application of the arm's-length debt test in the thin capitalization rules

The ATO has released its final Taxation Ruling TR 2020/4 (Income tax: thin capitalisation - the arm's length debt test) and Practical Compliance Guideline PCG 2020/7 (ATO compliance approach to the arm's length debt test) following the consultative drafts released last year.

TR 2020/4 replaces TR 2003/1, which is being withdrawn. The new TR provides further guidance to taxpayers on the unchanged existing law and aims to create a foundation for a more uniform application of the rules in practice.

TR 2020/4 also considers key legislative technical issues and provides clarity on record-keeping requirements and the interaction with the "arm's-length" principle under the transfer pricing rules. Of particular note are the following points set forth in the guidance:

- ▶ The arm's-length debt test (ALDT) standard is "higher than a prediction of a possible level of debt and calls for a prediction based upon evidence." The ATO is clear that it expects taxpayers to demonstrate an outcome that is "probable," rather than seeking the highest amount as a mere possibility.
- ▶ The arm's-length debt amount (ALDA) is a commercially reasonable position of the notional "stand-alone" Australian business, and not the capital structure and leverage preferences of shareholders.
- ▶ All relevant legislative factors need to be considered even where it is ultimately determined that a factor is not relevant.
- ▶ Fair market values of assets can be used for performing an ALDT analysis.
- ▶ Taxpayers relying on the test are obligated to comply with the record keeping requirements. However, a failure to prepare the requisite records does not result in an inability to rely on the ALDT.
- ▶ The ALDA could be different to the arm's-length capital structure for transfer pricing purposes.

PCG 2020/7 sets out the ATO's compliance approach and should be read in conjunction with TR 2020/4. There is no change to the structure but some feedback on the earlier draft PCG was incorporated (including key points of EY's submission). Consistent with the draft guidance, the final guidance requires taxpayers to demonstrate that their

notional debt levels, taking into account the reconstructed balance sheet, profit and loss statement, cash flows and credit rating, to address all of the quantitative and qualitative measures of an arm's-length debt amount by reference to comparable entities. The guidance includes reference to specific financial ratios that the ATO believes address the "relevant factors" specified in the law and provides an example calculation.

There are two changes of note in the final guidance:

- ▶ Taxpayers are still required to "self-assess" their risk zone position in light of the guidance. However, the guidance has been updated to include additional risk zones (white, low, low-moderate, medium and high), giving taxpayers greater scope to distinguish their risk. The risk zone then determines the level of compliance resources that the ATO will likely devote to reviewing the taxpayer's position. There are still specific low-risk zone criteria for inbound, outbound and regulated utilities taxpayers.
- ▶ It provides clarity on what constitutes a "commercial lending institution." In particular, the guidance excludes government-owned organizations from this definition (e.g., Clean Energy Finance Corporation).

Both sets of guidance apply before and after the date of issuance. In the case of the PCG, the guidance has effect from income years commencing on or after 1 January 2019.

The guidance is likely to mean an additional compliance burden for many taxpayers who will need to assess current and historic positions with potentially related additional documentation requirements.

EY has been in close consultation with the ATO on the ongoing development of this guidance. We provided a detailed submission to the ATO in response to the draft guidance, of which some feedback has been adopted by the ATO. We will continue to maintain a dialogue with the ATO to ensure the test is applied in a manner consistent with the commercial realities for taxpayers.

We also note that the ATO recently issued a thin capitalization concession for taxpayers impacted by COVID-19. Many taxpayers are experiencing impairment of asset values or requiring additional debt drawdowns to sustain their business through business interruptions. Given this, more taxpayers will potentially seek to rely on the ALDT for thin capitalization purposes. The ATO concession effectively allows taxpayers that would otherwise rely on the Safe Harbor Debt Amount to apply a simplified approach to the ALDT provided certain assumptions can be met.

Interest-free loans between related parties

PCG 2017/4DC2 is an update to PCG 2017/4 (ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions) to include a draft Schedule 3 dealing with outbound interest-free loans between related parties. This draft Schedule outlines the factors under which the risk score assigned to outbound interest-free loans made between related parties may be modified for the purposes of Schedule 1 of this Guideline. The risk "scoring mechanism" framework resembles the framework present elsewhere in PCG 2017/4. As with the ATO's overall PCG framework, taxpayers are required to "self-assess" their position in light of the guidance.

The ATO confirms the starting position is that an interest free outbound loan will be considered "high risk" from a transfer pricing perspective.

Previous ATO guidance (relevant to the predecessor transfer pricing provisions) had included a description of circumstances where a legal form loan agreement might be characterized as a contribution to equity (see Taxation Ruling 92/11). Reflecting the structure of subdivision 815-B, three exceptions to the "high risk" starting position in this Schedule are contemplated. The exceptions require evidence of one of the following:

- ▶ Zero interest rate is an "arm's-length" condition of the loan.
- ▶ The loan is "in substance" an equity contribution.
- ▶ Independent entities would not have entered into the actual loan and would have entered into an equity funding arrangement.

While three exceptions are presented, there is an emphasis on evidence the ATO would expect to see in support of an alternative "equity-like" characterization. Certain "framing considerations" and "relevant factors" are identified as matters to be taken into account. Four illustrative examples are included in the Schedule, each of them highlighting issues associated with factors relevant for consideration of whether the underlying transaction should be evaluated as an equity contribution.

We also understand the ATO Next Action team will resume work soon and streamlined assurance reviews under the Top 1000 Tax Performance Program will resume in October. The guidance now in final will no doubt assist taxpayers to understand their risks and inform them of approaches ATO case teams will take in these assurance-based reviews.

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