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# Global Tax Alert

# Australia: Detailed analysis on final taxation ruling and guidance on the Australian thin capitalization arm's-length debt test

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## Executive summary


On 12 August 2020, the Australian Taxation Office (ATO) released final Taxation Ruling TR 2020/4 (the Ruling) and Practical Compliance Guideline PCG 2020/7 (the PCG) relating to the use of the Arm's-Length Debt Test (ALDT) for the purposes of Australia's thin capitalization regime following its consultative draft released last year (PCG 2019/D3).

The Ruling addresses the application of the ALDT from a legislative perspective and the PCG provides administrative guidance to taxpayers when applying the ALDT. Historically Taxation Ruling TR 2003/1 attempted to cover both the legislative interpretation and guidance aspects of the ALDT, however, the ATO has split these into separate publications that are to be read together.

As the underlying legislation pertaining to the ALDT remains unchanged, the Ruling reiterates the ATO's view on the application of the legislation, materially consistent with TR 2003/1. The PCG, however, outlines the increased analysis and documentation expected by the ATO for a taxpayer to apply the ALDT. As flagged in the previous draft, the more stringent requirements reflect the ATO's overarching view that gearing in excess of the safe harbor debt amount for thin capitalization purposes should only be observed in limited circumstances.


Building a better working world

The type of analysis and evidence that taxpayers are expected to consider under the PCG approach may come as a surprise to many taxpayers in terms of being potentially a higher requirement than approaches that have been often followed historically in risk reviews or other ATO compliance products. It is the ATO's view that taxpayers often do not present adequate comparables and other evidence to substantiate their analysis and conclusions.

Like other PCGs, PCG 2020/7 contains "risk zones" (white, low, low-to-moderate, medium and high) guiding the level of expected ATO treatment and resource allocation. This represents a greater level of risk zone distinction than the ATO provided in its consultative draft PCG. However, in contrast to other PCGs, these risk zone criteria provide very limited circumstances where a taxpayer can achieve a low-risk rating when applying the ALDT. The limited circumstances for a low-risk rating in the PCG reflect the ATO's overarching view that fewer taxpayers should apply the ALDT.

# Detailed discussion

## Overview

### Application of the Guideline

The Ruling and PCG are intended to work in tandem to provide the ATO's legislative interpretation and administrative guidance on the ALDT. ATO Taxation Ruling TR 2003/1 which contained the ATO's previous ALDT documentation methodology and legislative interpretation has been withdrawn effective from 12 August 2020.

The Ruling applies to income years commencing both before and after 12 August 2020.

The PCG will have effect from 1 January 2019 and will apply where the ALDT has been used to establish an entity's maximum allowable debt from that date.

However, the current wording as to the date of effect of the PCG is unclear with regard to whether a risk to prior-year ALDT application is created by the increased requirements under the PCG. This is particularly relevant for taxpayers where the ATO has reviewed the application and conclusion under the ALDT for prior income years but has not formally "signed off" on the Arm's-Length Debt Amount (ALDA) in a way that would satisfy the "white" risk zone criteria.

In practice, taxpayers will want to meet the rigorous analysis and documentation requirements for both the historical ALDT positions open to review, as well income years beyond 1 January 2019.

The PCG does not apply to entities considered authorized deposit-taking institutions (ADIs).

### Overarching ALDT legislative framework

The ALDA of an entity is a notional amount applied to a hypothetical Australian business that would satisfy both of the following two tests:

- The notional debt capital the entity "would reasonably be expected to have throughout the income year" (the borrower's test).
- Arrangements that unrelated commercial lending institutions would "reasonably be expected to have entered into" (the lender's test).

The law requires the ALDA to satisfy both tests. Therefore, the ALDA is the lower of the amounts determined under each test.

The ATO views the "would reasonably be expected" tests as higher than a prediction of a mere possible level of debt; rather the amount must be probable. Further, the borrower test is not seeking to identify the highest debt amount that may be financially supportable. More specifically, an amount that a borrower "would" borrow must be distinguished from an amount the borrower "could" borrow. Under the new guidance taxpayers need to demonstrate that the notional debt levels, taking into account their reconstructed balance sheet, profit and loss statement, cash flows and credit ratings adequately address all of the quantitative and qualitative measures of an arm's-length capital structure by reference to comparable entities. In particular, the ATO notes that it is imperative that the notional amount must allow for an appropriate "risk adjusted return on equity" (i.e., having regard to the relative level of gearing) to investors in a broader industry context.

The application of both tests is statutorily constrained to the generally narrower subset of the actual Australian borrower being a hypothetical stand-alone "notional Australian business" as defined by the "factual assumptions" and guided by the "relevant factors" contained within Division 820. These concepts are discussed in further detail below.

## ATO compliance approach

The ATO firmly asserts that they have found limited circumstances of entities geared in excess of 60% of net assets and accordingly consider the safe harbor should produce a higher maximum allowable debt than the ALDT in most circumstances.

Limited low risk exceptions are provided to evidence where it is more common to operate with higher debt to equity ratios (such as for certain regulated infrastructure entities). Private equity does not get a specific mention in the PCG but private equity portfolio investments are potentially another example where a higher debt tolerance is appropriate.

On this basis, the ATO has only outlined the following limited circumstances which would achieve a low-risk status:

- For inbound investors: borrowing being from a commercial lending institution that is not an associate of the borrower; the only exception to this requirement is where an associate borrows from a commercial lending institution and provides the debt funding on back-to-back terms. The borrowing must occur without any form of parental/associate credit support in situations involving a purely Australian domestic business. Taxpayers are cautioned that there will be significant scrutiny as to whether there is some form of credit support provided that underpins the third-party borrowings. The taxpayer must also have no foreign operations or be an associate of another Australian entity that is an outward investor.
- For outbound investors: the taxpayers are widely held ASX-listed entities which are outward investing entities (and which are not also an inward investing entity) with a publicly issued credit rating for the entire global group, and where it can be shown that the same credit rating (based solely on third-party debt) applies to the notional Australian business. Effectively, the ATO wants to ensure that the Australian balance sheet is not being disproportionately geared relative to the rest of world operations.
- For certain regulated utilities providers where 70% of its total assets comprise a regulated asset base (RAB): a specified set of financial ratios, including net debt to RAB leverage ratio equal to or less than 70%, and cash flow from operations interest cover ratio equal to, or greater than 2.7 times.

In all other cases, however, entities relying on the ALDT, particularly those with related party debt, will constitute low-to-moderate, medium, or high-risk ratings unless ATO "white zone" sign-off has been obtained. This represents a change from the draft PCG, in which there were only white, low and medium-high risk ratings. The inclusion of additional risk ratings gives taxpayers greater scope to distinguish their risk.

In contrast to other PCG's that encourage behavioral change to achieve low-risk status, the PCG contains a limited ability for taxpayers to change their risk rating, outside of abandoning the ALDT or having white-zone discussions with the ATO. Additionally, the PCG does not consider materiality that would allow taxpayers to vary the breadth and depth of the ALDT analysis commensurate with the quantum of debt involved.

Taxpayers meeting the low or low-to-moderate risk criterion can expect a lower level of ATO scrutiny, generally limited to a review of their satisfaction of the low-risk criteria, and reviews by exception.

Taxpayers with a medium or high-risk rating should expect that the ATO will apply compliance resources to review the ALDT in detail and their compliance with the PCG and Ruling, with taxpayers exhibiting high-risk ratings expected to face significant scrutiny. Therefore, it is critical that taxpayers consider their strategy to address the PCG and Ruling and/or the relative merits of having ATO white-zone discussions.

### Reportable tax positions

The risk zone self-assessed under the PCG is expected to be disclosed in the Reportable Tax Positions (RTP) Schedule, filed by some taxpayers with their corporate income tax returns. While the self-assessment under the PCG is not mandatory, if a taxpayer is unable to, or chooses not to, complete the self-assessment, this is required to be disclosed on the RTP.

While the RTP instructions relevant to the PCG have not yet been released, we note that in relation to the RTP disclosures for PCG 2017/4 (the ATO's compliance approach to cross-border related party financing arrangements), not completing the self-assessment is viewed by the ATO as akin to exhibiting characteristics of the high-risk zone as they are categorized within the same disclosure category.

This disclosure will further distinguish taxpayers that present higher integrity risk from an ATO perspective and could conceivably hasten the ATO compliance action for certain taxpayers.

### Outward vs inward

The ATO's general areas of focus differ depending on whether a taxpayer is characterized as outward or inward for thin capitalization purposes. In particular:

- In the context of inward investing entities, where third party senior debt is supplemented with related party debt, the related party debt significantly increases the risk profile of the entity with regard to the application of the ALDT.

- In the context of outward investing entities, the presence of significant relatively lowly geared foreign operations significantly increases the risk profile of the Australian entity regarding the application of the ALDT. This is because, as a starting point, the ATO will require taxpayers to demonstrate the amount an independent lender "would" be willing to lend based solely with respect to the notional Australian business generally without the financial support from international operations.

## Important PCG concepts

Important concepts for taxpayers to consider in relation to the PCG include:

- Arm's-length terms and conditions
- Consideration of all relevant factors and their respective weighting

### Arm's-length terms and conditions

#### *Comparables*

The ATO clearly prefers Australian market comparables. However, to the extent it can be demonstrated that there are no Australian comparables then comparables from other markets may be used.

For regulated industries, the ATO specifies overseas regulated markets are not considered to be comparable given the issues expected in quantifying adjustments.

However, given there are very few Australian comparables in the industry, in our view the ATO's concerns about adjustments can be mitigated by choosing suitable comparables from comparable markets in the same way that would occur in transfer pricing benchmarking studies. Choosing non-Australian comparables also reflects that capital markets are global, and that commercial lenders are generally not constrained by geographic borders in determining who they will lend to.

#### *Terms and conditions*

In arriving at an ALDA, the analysis must consider and give effect to the arm's-length terms and conditions for each debt interest on which the stand-alone notional Australian business would have borrowed.

The ATO has made it clear that taxpayers cannot simply rely on a transfer pricing analysis to demonstrate this. For example, a taxpayer could have their interest rates adjusted down for transfer pricing purposes, while for ALDT purposes the interest rate could be adjusted up, thereby limiting the entity's debt capacity.

The PCG also 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).

Therefore, it is important to perform further analysis before relying on transfer pricing interest rate benchmarking in ALDT calculations. During the draft PCG consultation, we suggested that the ATO limit these potential interest rate adjustments to extreme circumstances whereby unrealistically low interest rates are used to support excessive gearing levels. The ATO has ultimately upheld its strict interpretation on this matter which is further demonstrated by the example provided in the Ruling at paragraph 101.

#### *Credit rating/credit worthiness*

The ATO has made it clear that taxpayers cannot rely on their actual capital structure to determine the credit rating and then use this credit rating to identify the comparable companies to assess whether the gearing of a particular taxpayer is arm's length.

However, the ATO has acknowledged that the credit rating methodologies may be useful in some cases (e.g., identifying limits/ranges for certain financial ratios) and may help inform the weightings of the relevant factors.

#### *Covenants*

Covenants in third-party debt arrangements should be considered. When covenants are used to help determine the ALDA, the ATO expects a taxpayer to assume there is sufficient headroom built into the analysis (i.e., the taxpayer cannot adopt gearing that means the taxpayer breaches a covenant). As the ATO has not provided an indication of what constitutes "sufficient headroom," a documented commercial perspective on this matter is recommended for purposes of this analysis.

In noting the above, it is important that the type of covenant and its intended restrictions are considered. For example, an entity may negotiate certain financial covenants in order to agree on a desirable interest rate with a lender. Therefore, the covenants should not be read as a restriction on the level of total debt the notional Australian business would draw-down.

### Consideration of the relevant factors

In determining an ALDA, the taxpayer must address certain relevant factors: both of a qualitative and quantitative nature.

The ATO specifies that all the factors listed must be considered, although the weight given to each factor in the analysis will vary depending upon the facts and circumstances of the case. It is expected that the analysis provides a detailed explanation and evidence as to how and to what degree each of the relevant factors are weighted.

Some factors will be more important for a borrower and some for the lender.

*Quantitative factors*

With respect to quantitative factors (that is, factors that can be used to directly determine an amount), it is granted some may have more bearing than others and as such it would be appropriate to weight these quantitative factors accordingly.

If a specific ratio is outside an appropriate comparable range, it may be necessary to adjust the ALDA to account for this factor.

While the PCG does not rule out the use of a single financial ratio to support an ALDA (i.e., 100% weighting), the ATO expects to see evidence to demonstrate why the weightings are appropriate.

*Qualitative factors*

Taxpayers must consider whether each qualitative factor is adverse, neutral or supportive of the amount quantified above.

*Return on equity capital*

This corroborative exercise is designed to test the commerciality of returns attributable to hypothetical owners having regard to a revised capital structure reflecting the borrower's amount.

The ATO will adopt a capital asset pricing model (CAPM) to corroborate that the risk adjusted returns on equity (i.e., adjusted for relative levels of gearing) of the notional Australian business are consistent with the expected rates of returns for other comparable companies.

This approach requires several input parameters including market alphas and betas. This exercise can be particularly difficult for private companies or where there are few comparables in the market. Given the inherent difficulties and subjectivity in applying the CAPM (particularly to private companies), during the draft PCG consultation we worked with the ATO to develop an alternative to provide comfort that the relative return earned by shareholders through their debt and equity interests is reasonable. However, the ATO has ultimately upheld their original approach in relation to the CAPM.

*Gearing*

The ATO expects to compare the gearing levels across a global multinational group to ensure that the relative gearing of the Australian operations is consistent with other group comparable entities. If the gearing of the Australian entity is an outlier against the global gearing profile this is a strong risk indicator for the ATO.

However, if a taxpayer cannot demonstrate independent comparables have similar gearing levels, gearing consistent with the global multinational group will not be accepted by the ATO.

## Commercial rationale for related party debt

The PCG notes that where specific commercial rationale for the debt cannot be identified and supported (i.e., the debt appears to have been introduced to achieve a tax outcome) this could make it difficult for the taxpayer to sustain that the amount of debt capital is reasonable.

We have some concerns that a "purpose" test encroaches on general anti-avoidance rule (Part IVA) concepts and often the origins and purpose of an entity's debts may not be clear to management.

Therefore, we would posit that the historic knowledge of why debt was used to capitalize the business and the precise tracing of debt to purpose is not necessarily required. In many cases, refinancing of existing loans could be an acceptable commercial rational.

Between the Ruling and PCG, the ATO also states that the capital structure and leverage preferences and risk appetite of the shareholders and management are not relevant to determine what amount of debt would reasonably be expected to be borrowed.

It is accepted that the very nature of the ALDT is to objectively assess the gearing level, and therefore such leverage preferences may not be relevant. However, in our view the group policies and view of management in other aspects cannot be completely disregarded in applying the test.

## Documentation and analysis to support the application of the ALDT

The law requires that the relevant documentation is in place by the time the taxpayer files its tax return for a year, otherwise the taxpayer is exposed to administrative penalties.

However, the Ruling confirmed that a failure to prepare the appropriate documentation by the due date of the tax return does not preclude an entity's ability to rely on the ALDT.

On another positive note, the PCG is very detailed in terms of what the ATO expectations are for documentation and analysis to support the application of the ALDT and the resulting ALDA.

### Annual documentation updates

The ATO specifies prior year ALDT analyses can be taken into account in assessing the ALDT for a relevant income year to the extent that the analysis relates to the same debt capital on issue and there have been no material changes to the business operations or performance. In this instance, however, there remains a need to produce annual documentation which demonstrates there is no material change in the business and reviews the financial ratios relied upon using data relevant to the current period.

To the extent there is material change or new debt capital has been issued, a more comprehensive updated analysis and documentation would be required.

## Interaction with the "arm's-length principle" in transfer pricing and reclassification of debt to equity treatment in Division 974

### Transfer pricing

The PCG also makes it clear that, although the ALDT involves some transfer pricing concepts, the ALDT itself is a distinct and separate analysis.

The application of the ALDT is statutorily constrained to the generally narrower subset of the actual Australian borrower being a hypothetical stand-alone "notional Australian business." This reduces the ability to rely on arm's-length transfer pricing analysis performed under Division 815, unless no adjustments are required to be made to distinguish the Australian borrower from the "notional Australian business."

In particular, for ALDT purposes, the arm's-length terms and conditions of the debt for ALDT purposes might result in an interest rate that is higher than under a transfer pricing analysis.

In our view, inbound taxpayers that have appropriately applied the ALDT, should also be able to rely on that capital structure for transfer pricing purposes in determining an arm's-length interest rate on related party debt. More specifically, for inbound taxpayers it should be possible to have one "ALDA." We have recommended that the ATO grant this concession given the significant analysis and more restrictive nature of the ALDT should result in a more conservative capital structure than allowable under Division 815.

### Reclassification of debt to equity

A related matter is the position in ATO Tax Determination TD 2019/10 that is contrary to a common view held by many taxpayers and practitioners that the Debt/Equity provisions in Division 974 should apply in priority to the more general transfer pricing provisions in Division 815.

This view flows from the long standing ATO approach captured in TR 2010/7 that the thin capitalization provisions attend to "excess" debt levels, while the transfer pricing provisions attend only to the pricing of the existing debt.

Where a taxpayer satisfies the ALDT, it would be inappropriate, in our view, for a taxpayer to then face the possibility of the debt being recharacterized under the transfer pricing provisions.

EY submitted comments on the draft PCG that raised our concerns with the interaction of Division 974 and the transfer pricing provisions, however no change to the views above have been released by the ATO.

## Thin capitalization concession in light of COVID-19

It is also worth noting that the ATO recently issued a thin capitalisation concession for taxpayers impacted by COVID-19. Many taxpayers are experiencing an impairment of asset values or requiring additional debt draw-downs to sustain their businesses through business interruptions. For this reason, 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.

## Implications

Key takeaways from the release of the PCG are:

- Date of effect is 1 January 2019, however in practice, the analytical approaches and level of evidence outlined in the PCG are likely to be the ATO's expectation of analysis applied to prior years.
- The ATO requires taxpayers relying on the ALDT to undertake analysis and documentation above and beyond previous established practice yet indicates such analysis would still not be expected to result in gearing levels above the safe harbor debt amount for most taxpayers. Among other things, the result of the ALDT analysis needs to be shown to be "probable" and not just possible.
- The ATO expects limited circumstances in which taxpayers would gear in excess of 60%. The ATO has highlighted an exception for the regulated infrastructure industry, but there is no specific acknowledgement provided in relation to other industries that similarly adopt higher gearing levels.
- The ATO's low-risk zone scenarios are very restrictive, and the vast majority of ALDT's will be subject to some level of ATO compliance activity.
- The ATO's guidance is now more detailed (which is welcomed) but still results in many practical application challenges.

## Ongoing consultation

EY has been, and continues to be, involved in ongoing consultation with the ATO regarding the practical application of the PCG. In this regard, the ATO continues to encourage taxpayers to proactively engage with them to address specific ALDT application issues. EY has worked closely with taxpayers in these discussions to increase the clarity on the ATO's expectations.

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