

Australian Tax Office issues draft ruling on thin capitalization arm's-length debt test

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Executive summary

The Australian Taxation Office (ATO) released, on 5 April 2019, a draft ruling [TR 2019/D2 \(draft ruling\)](#) with respect to the requirements for the application of the arm's-length debt test (ALDT) in the thin capitalization rules.

The draft ruling proposes that the guidance is to apply both before and after its date of issue, despite there being no change to the law concerning the ALDT. The eventual final ruling, along with a planned draft Practical Compliance Guideline (PCG - currently under development), will replace an existing taxation ruling. Comments on the draft ruling (and practical compliance guideline) are due by 31 May 2019.

The Commissioner of Taxation's (the Commissioner) interpretation in the draft ruling regarding the application of the ALDT may require a stricter application of various elements of the ALDT than the position taken by many taxpayers.

The draft ruling will need careful analysis by taxpayers using or intending to use the ALDT. At a minimum, documentation prepared by taxpayers should consider the key issues highlighted in this Tax Alert.

In the analysis, the following issues should be considered:

1. The draft ruling represents useful guidance on the unchanged existing law and aims to create a foundation for a more uniform application of the rules in practice.
2. Compliance approaches currently vary substantially, and the draft ruling is aimed at achieving greater consistency through what appears to be a more robust analysis given the increasing number of taxpayers relying on the ALDT.
3. The upcoming PCG is anticipated to provide further ALDT application guidelines as well as guidance around ATO risk profiles. The PCG will be linked to Reportable Tax Positions and ATO Streamlined Assurance Reviews with responses informing ATO compliance approaches.
4. The Labor opposition has foreshadowed potential changes to the thin capitalization rules if they were to win government in the upcoming election, which could impact on the prospective availability of the ALDT. However, given the retrospective application of both the draft ruling and PCG, this issue would remain highly relevant for many taxpayers.

This Tax Alert considers the draft ruling and its impact in detail.

Detailed discussion

Background

The ALDT has been part of Australia's thin capitalization regime since its enactment in 2001. When introduced, it was envisaged to be "of most use in those industries where it is common practice to operate with higher debt to equity ratios" (at the time the safe harbor debt effectively used a 3:1 debt:equity ratio).

In May 2013, the Board of Taxation (BoT) was asked to review the use of the ALDT following the reduction in the safe harbor level of debt to 1.5:1 debt:equity ratio, in the expectation that use of the ALDT would increase. At that time the ALDT was not widely used by Australian taxpayers: the ATO noted in 2013 that 97% of Australian taxpayers submitting a thin capitalization schedule applied the safe harbor.

The BoT reported to Government in 2014. The Report had various recommendations, but overall found that issues with the ALDT were largely administrative and that the ATO should provide revised guidance. The recommended ATO administrative guidance included the use of case study

examples, information regarding the ATO's data sources, the use of earnings before interest, taxes, depreciation and amortization (EBITDA) as a relevant metric and guidance in relation to the link between the ALDT and Australia's transfer pricing rules. The BoT recommended that the operation of the ALDT be reviewed again in a further three years "in the event that it appears the ATO's administrative guidance on the ALDT is no longer appropriate."

More than four years later, the ATO draft ruling is one element of the ATO revised guidance in the form of draft interpretative guidance. The release reflects that significantly more taxpayers are using or considering the ALDT as a basis for deductibility of funding costs, as Australia has tightened its thin capitalization rules.

The draft ruling follows an original 2003 Taxation ruling (TR2003/1) which had an important qualification - TR2003/1 was a "Taxation ruling," but one that did not have "interpretative" status. In the fine print it was noted that TR2003/1 was not a "Public ruling" that ruled on the application of the relevant tax law. As such, it remains no more than administratively binding on the Commissioner.

This draft ruling is timely as an interpretative document alongside the planned changed administrative guidance (the PCG). The status of the 2003 ruling may become relevant when considering the administrative aspects including the date of effect in the draft ruling.

ALDA is the lower of two notional amounts under borrower and lender tests

The draft ruling clarifies that the arm's-length debt amount (ALDA) of an entity is a notional amount 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 test)
- ▶ Arrangements that unrelated commercial lending institutions would "reasonably be expected to have entered into" (notional lender test)

The draft ruling reiterates the (unchanged) law and the interpretation of that law, that the borrower test and lender test are two separate tests that must be considered separately.

Further, the draft ruling clarifies that the ALDA is required to satisfy both the borrower and lender tests. In this regard there appears to be an underlying message that the ATO would not generally expect these amounts to be the same.

“Would reasonably be expected” tests

The borrower test and lender test, respectively, seek to determine the maximum amount that the notional borrower “would reasonably be expected” to have borrowed and the maximum amount that the notional lender “would reasonably be expected” to have lent.

The draft ruling refers to the interpretation of the phrase “would reasonably be expected” from the High Court in the *Peabody 1994* decision concerning Australia’s General Anti-Avoidance Regime (Part IVA of the ITAA 1936):

A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.

The draft ruling also refers to the Full Federal Court decision in the *Peabody* case in which Justice Hill noted:

“expectation” requires that the hypothesis be one which proceeds beyond the level of mere possibility to become that which is the expected outcome.

In the Commissioner’s view, in the context of determining the ALDA, there is therefore a clear distinction between what the notional borrower “would” borrow and what the notional borrower “could” borrow.

The draft ruling clarifies the ATO’s interpretation that while the notional lender test may determine the maximum amount a notional lender would lend (and therefore the maximum amount the notional borrower “could” borrow), it does not follow that the notional borrower would necessarily borrow this maximum amount.

The amount the notional borrower would reasonably be expected to have borrowed requires its own analysis, taking into consideration objective evidence including but not limited to the appropriate return on equity to its investors.

This requires the taxpayer being able to evidence not just the arm’s-length financial metrics which in turn determine the ALDA, but also the facts which evidence the amount of debt the notional independent borrower would reasonably be expected to have borrowed.

Despite there being no change in law, the above appears to represent a higher required threshold of analysis, as well as requiring evidence and documentation to be compiled and maintained to support the position.

Capital structure and leverage preferences of shareholders not relevant

The ALDT states that the ALDA must be determined by reference to the “factual assumptions.”

The explanatory memorandum to the Bill which introduced the ALDT clarifies that the policy intent of the “factual assumptions” is to hypothesize the notional Australian business of the borrower.

For the most part, this requires the determination of the ALDA to be determined in relation to the credit strength and financial metrics of its Australian operations only.

Among other factual assumptions made, this is achieved by specifically excluding the balance sheet and profit and loss statement impact of foreign branch operations, controlled foreign entity debt and equity and associate entity debt.

Further, any guarantee, security or other form of credit support provided to the notional borrower is required to be disregarded.

However, the Australian business must otherwise be assumed to have been carried in the same circumstances as actually existed.

The factual assumptions further restrict the analysis to that of the notional Australian business without regard to its shareholders or its membership of a global group.

The ATO concedes that the factual assumptions do not require management and shareholders to be disregarded. However, it explicitly notes that subjective preferences of management or shareholders (for example choosing to be highly leveraged) about the notional Australian business should be disregarded for the purposes of determining the ALDA.

This is based on the ATO’s interpretation that an objective assessment of the amount the notional borrower would reasonably be expected to have borrowed is required for the ALDA to be determined under the borrower test.

Notwithstanding the above, the draft ruling notes that management strategies and operational changes implemented in relation to the business may be considered in the context of the impact these may have on the application of the relevant factors to determination of the ALDA of the notional Australian business. This confirms also the ability to incorporate forecast data in determining the ALDA.

Factual assumptions and relevant factors

The tests require adopting specific statutory “factual assumptions” and specify various “relevant factors” which should be considered. All the factors listed must be considered in the context of the notional Australian business even where it may ultimately be concluded that a particular factor is not relevant. Further, although no specific guidance is provided it is anticipated that the weight given to each factor in the analysis will vary depending upon the facts and circumstances of the case: these may vary by industry and credit rating agencies’ materials may provide relevant guidance. Some factors will be more important for a borrower and some for the lender.

Asset valuations

The draft ruling makes it clear that, although the financial statements would generally be expected to form the starting point of an ALDT analysis, a taxpayer is not precluded from relying on alternate asset values to those disclosed in the financial statements for the application of the relevant factors to the notional Australian business. The law is clear despite the legislation in Parliament to remove the specific ability to revalue assets for the purposes of the thin capitalization safe harbors unless the revaluations are adopted in financial statements.

The adjustments may result in either an increase or a decrease of the ALDA determined, depending on the commercial likelihood of a lender attributing value to certain assets (or not) of the notional Australian business.

For assets booked at a historic value which is lower than their existing market value, if a notional commercial lender would be reasonably expected to attribute that market value, that greater amount may be relied upon for the purposes of determining the ALDA (evidence of value would be required).

For certain assets to which a notional commercial lender would be reasonably expected to attribute a lower value than book value, that lesser amount only may be relied upon when determining the ALDA.

Notional amount throughout income year

The draft ruling states that the legislation requires the determination of the ALDA “throughout the income year.” The draft ruling notes that although Subdivision 820-G outlines the methods for calculating the average value, there is no specific requirement to calculate the average

value in applying the ALDT. In applying the ALDT, there is no single approach for determining the ALDA throughout the income year and the appropriate approach will depend on the specific facts and circumstances of the taxpayer for the relevant year.

Interaction with transfer pricing rules

The draft ruling reiterates that a determination of an ALDA, and the law under which that analysis is performed, is distinct and separate from a transfer pricing analysis determined under section 815-B (or the Associated Enterprises article of a Double Tax Agreement).

This is because the ALDT analysis is confined to the notional Australian business defined by the factual assumptions and the ALDA determined by reference to the relevant factors applied to that notional Australian business.

This notional hypothesis is narrower than the commercial and economic reality of the borrower which is the focus of an 815-B transfer pricing assessment (which may for example include membership of a broader corporate group).

So, there are important differences in the respective statutory frameworks. As such a transfer pricing assessment of a loan is not sufficient to be relied upon for the purposes of determining an ALDA, and in many cases the ALDT may not be appropriate for determining whether the terms and conditions associated with the loan are arm’s length.

The ATO may be seeking to highlight that taxpayers may be incorrectly performing transfer pricing analysis supporting an economic maximum lending amount without due regard to the ALDT provisions.

An important element of the ALDT is that the taxpayer should assume no guarantee, security or other form of credit support and that the only business is the Australian business of the taxpayer. This requirement is not present in the transfer pricing rules in Subdivision 815-B. On this basis, it is possible that the ALDA determined for ALDT purposes is different to the arm’s-length capital structure determined for transfer pricing purposes.

Relying on ALDA within amendment period

The draft ruling clarifies that where a taxpayer is within their prescribed amendment period in relation to a prior income year, they are not precluded from amending the income tax return for that income year to rely on the ALDA as their maximum allowable debt amount.

This is the case even where they filed that income tax return based on the safe harbor debt amount or world-wide gearing debt amount as their maximum allowable debt amount.

The draft ruling then notes that penalties might apply where taxpayers have not maintained contemporaneous documentation by the date they file their income tax returns.

Retrospective application

In our view the Commissioner's interpretation in the draft ruling of the application of the ALDT may require a stricter application of various elements of the ALDT than the position taken by many taxpayers.

Given the above, we will raise in our submission that:

- ▶ We see it as problematical if the final ruling is proposed to apply both before and after its date of issue. In our view the final ruling or significant aspects thereof should operate prospectively rather than retrospectively.

- ▶ At a minimum, we will suggest that the ATO should focus compliance resources on forward tax positions, without seeking to reopen prior-year ALDT calculations.

Implications

Any taxpayer considering use of the ALDT will need to prepare documentation and evidence following the key issues highlighted in this Tax Alert.

Taxpayers will need to consider the ALDA throughout the year to take account of any material changes of circumstances.

Given the proposed retrospective application of this ruling taxpayers should review their existing ALDT documentation and analysis in light of this new guidance.

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