

Australian Taxation Office releases draft guidance on arm's-length debt test for purposes of Australia's thin capitalization regime

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On 28 August 2019, the Australian Taxation Office (ATO) released draft guidance, [PCG 2019/D3](#) (draft PCG), which sets out the ATO's proposed compliance approach for the use of the arm's-length debt test (ALDT) for the purposes of Australia's thin capitalization regime. The 41-page draft PCG augments the April 2019 draft ruling TR 2019/D2 (draft Ruling).¹

The ATO focus on providing detailed expectations around the application of the ALDT arises from:

- ▶ More taxpayers relying on the ALDT since the safe harbor debt amount ratio was reduced to 60%, with further increases expected as a result of tax only valuations being fully phased out from 1 July 2019.
- ▶ The ATO emphasis on a holistic approach to related-party cross-border financing.
- ▶ The ATO's perceived inconsistencies in the application of the ALDT including:
 - Insufficient regard to the legislative factual assumptions that must be made and the legislative list of factors that must be considered when determining the arm's-length debt amount (ALDA).
 - Concerns with taxpayers determining amounts that “could” have rather than “would” have been borrowed given relevant facts and circumstances.

Although the draft PCG is proposed to apply to ALDT determinations from 1 July 2019, given that the ATO considers that the PCG does not reflect new law, but is merely a clarification of the existing thin capitalization legislation, it will be highly relevant for taxpayers with current disputes and discussions with the ATO in relation to ALDTs for prior years. More specifically, the draft PCG:

- ▶ Increases the analysis and documentation required to apply the ALDT.
- ▶ Justifies a “more rigorous analysis than the safe harbour and worldwide gearing tests” on the basis that Australian businesses outside regulated utilities would not be expected to have debt at levels greater than 60% of their net assets.
- ▶ Contains “risk zones” (white, low, and medium-high) which unlike other PCGs are not based on bright line financial ratios/metrics and provide very limited opportunity for low-risk ratings.

To achieve low-risk status there are three specific criteria:

- ▶ For inbound investors: borrowing from non-associated and purely non-related parties, without any form of parental/associate credit support in situations where the business is purely an Australian domestic one.
- ▶ 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 applies to the notional Australian business.
- ▶ For regulated utilities providers: a specified set of financial ratios, including net debt to Regulated Asset Base leverage ratio equal to or less than 70%, and cash flow from operations interest cover ratio equal to, or greater than 2.7 times.

All other scenarios will constitute medium-high risk rating unless ATO “white zone” sign-off has been obtained. The risk zone self-assessed under this draft PCG will need to be shown in the Reportable Tax Positions (RTP) Schedule.

A medium-high rating means that administrative concessions are not available, and taxpayers are expected to invest significant time and resources to comply with the new documentation requirements outlined within the draft PCG and draft TR 2019/D2 (which replaced the six-step methodology in the to-be-withdrawn TR 2003/1).

These new requirements include the need for companies planning to apply the ALDT to:

1. Revisit the arm’s-length conditions for both related and unrelated party debt whereby the tested entity is evaluated as a stand-alone entity when applying the ALDT despite being treated as part of a global multinational group when otherwise applying the transfer pricing provisions. Interest rates on debt capital may be higher for ALDT purposes than arm’s-length interest rates for transfer pricing purposes.
2. Consider each relevant factor, establish a weighting, and provide a rationale for each of these factors. The ATO argues it will not be appropriate to rely on a single financial ratio to support an ALDA. Further, if a specific ratio is outside an appropriate comparable range it may be necessary to adjust the ALDA to account for this factor.
3. Calculate a risk-adjusted return on equity which incorporates the impact of debt:equity levels (i.e., levered and unlevered capital asset pricing model “CAPM” analysis).
4. Compare debt:equity levels across a global multinational group to ensure that the relative debt:equity levels of the Australian operations are consistent with other group comparable entities.
5. Detail the commercial rationale for related-party debt. The draft 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 raise concerns with respect to the entire amount of the related-party debt capital.

These new requirements may come as a surprise to many taxpayers given the generally accepted approaches that have been historically followed.

On a more positive note, the draft 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. However, for many taxpayers it may be difficult to meet these expectations. EY will continue to work with the ATO to ensure a practical application of the ALDT which addresses ATO concerns and ensures that the ALDT remains a viable option for taxpayers. In this regard, comments on the draft PCG can be submitted until 9 October 2019 and EY is actively involved in this consultation process.

A Tax Alert detailing the implications of this draft PCG for taxpayers wishing to apply the ALDT will be forthcoming.

In light of the significant issues identified above and in the draft TR 2019/D2, taxpayers should carefully review capital structures and intra-group financing arrangements.

Endnote

1. See EY Global Tax Alert, [Australian Tax Office issues draft ruling on thin capitalization arm's-length debt test](#), dated 10 April 2019.

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