ATO focus on cross-border funding continues

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In brief

The focus by the Australian Taxation Office (ATO) on cross-border debt (and related instruments) continues with three new pieces of draft guidance released today:

- TD 2018/D4 - *Income tax: thin capitalisation - valuation of debt capital of the purposes of Division 820*
- TD 2018/D5 - *Income tax: what type of costs are debt deductions within scope of subparagraph 820-40(1)(a)(iii) of the Income Tax Assessment Act 1997?*
- PCG 2017/4 - *Draft Schedule 2: ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*

Each of the guidance documents highlight perceived risks identified by the ATO in relation to cross-border debt financing. Moreover, each document adopts a position that would generally result in a reduction in the thin capitalisation safe harbour for affected taxpayers (in respect of the two tax determinations) or a greater risk of compliance resources being devoted to taxpayers (in respect of the Practical Compliance Guideline (PCG) schedule).

Taken together, the guidance reinforces the ATO's continuing 'laser-like' focus on the various tax rules applicable to cross-border debt across issues including the:

- pricing of the debt
- quantum of debt (including thin capitalisation rules), and
- deductibility of costs associated with debt (including proposed hybrid mismatch rules).

The ATO has also foreshadowed guidance in relation to interest-free loans, the interaction between tax debt/equity and transfer pricing rules as well as a range of thin capitalisation issues including the ATO's compliance approach, the revaluation of mining rights and the operation of the arm's length debt test. In addition, draft legislation is expected later this year that will eliminate the choice to adopt off balance sheet asset revaluations for the purposes of the thin capitalisation safe harbour rule.

This focus is expected to continue, and taxpayers should be prepared to explain and defend their positions in respect of all cross-border related party debt to the ATO.

In detail

Thin capitalisation - valuation of debt capital

Tax Determination TD 2018/D4, foreshadowed by the ATO two years ago, follows on from Taxpayer Alert TA 2016/9: Thin capitalisation - incorrect calculation of the value of 'debt capital' treated wholly or partly as equity for accounting purposes - unsurprisingly, it reaches a similar conclusion.

The technical issue considered in the draft determination turns on how section 820-680 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies to instruments which are debt for tax purposes but are treated wholly or partly as equity for accounting purposes. Section 820-680 requires compliance with accounting standards for the purpose of identifying the taxpayer's assets and liabilities and in determining their value.

Many taxpayers have taken the view that the legislative reference (subsection 820-680(1)(b)), which refers to '*the value of… liabilities (including.. debt capital)',* means that only the amount of a debt interest that is accounted for as a liability should be treated as debt capital.

The ATO rejects this view and instead suggests that the 'entity's debt capital must be valued in its entirety in the manner required by the accounting standards', i.e. regardless of the division of any value between equity or liabilities. This view is consistent with the ATO's guidance noted in *TA 2016/9,* and therefore is not unexpected (notwithstanding the strong arguments to the contrary). However, additional technical explanation of this view would be helpful.

The draft determination includes three examples as to how the Commissioner's view applies to different instruments (loan note, perpetual note and mandatorily redeemable preference shares). However, the explanation for each example is incomplete and therefore a number of questions are left unanswered.

For instance, Example 3 deals with mandatorily redeemable preference shares (MRPS) which are a compound financial instrument under Australian accounting rules. This example does not provide guidance on what happens in years after the shares are first issued. Under accounting rules, the liability component of the MRPS would generally accrete in value whilst the equity component would be held constant. It is not clear from the draft determination whether, under the approach being suggested by the ATO, this would mean that the entity's debt capital would be the sum of these accounting values, which would exceed the face value of the instrument.

The draft determination also suggests that Australia's transfer pricing rules may also operate to substitute arm's length conditions *'including in relation to its debt capital'*. No further explanation of this ATO view is provided in the draft determination.

Hopefully, these unanswered questions will be resolved in the final version. Taxpayers have until 31 August 2018 to make a submission on this draft determination.

Thin capitalisation - costs that are debt deductions

Tax Determination TD 2018/D5 provides the Commissioner's draft view as to what type of costs are debt deductions for thin capitalisation purposes. The draft determination takes an expansive view of the meaning of debt deductions under subparagraph 820-40(1)(a)(iii) of the ITAA 1997.

This subparagraph treats any amount *'directly incurred in obtaining or maintaining the financial benefits received'* as being a debt deduction. The draft determination takes a broad view of the meaning of '*directly incurred'* and also when costs might be considered to be in *'obtaining or maintaining'* financial benefits.

This broad interpretation results in a conclusion within the draft determination that the following non-exhaustive list of costs would be debt deductions for thin capitalisation purposes:

a) tax advisory costs incurred in relation to the debt capital, which relate to activities including, but not limited to, drafting of the agreement and valuing the debt capital
b) establishment fees
c) fees for restructuring a transaction
d) stamp duties
e) regulatory filing fees (for example Australian Securities and Investments Commission lodgment fees)
f) legal costs of preparing documentation associated with the debt capital, and
g) costs to maintain the right to draw down funds.

The definition of 'debt deduction' is relevant both because the thin capitalisation rules apply to deny debt deductions (if the thin capitalisation limits are breached) and because only debt capital which gives rise to debt deductions impacts the calculation of thin capitalisation limits.

The draft determination includes MRPS as the sole example of financing affected by this ruling. However, we anticipate broader impacts - for example, certain interest-free loans may be included in adjusted average debt even if the instrument does not itself give rise to debt deductions.

Accordingly, the view in the draft determination could result in some taxpayers having higher 'adjusted average debt' (and consequently greater risk of thin capitalisation denial) than previously may have been anticipated.

Any determination as to whether costs are directly incurred in obtaining or maintaining the financial benefits will require an inherently factual analysis specific to the particular instrument and costs which could mean that the benefit of the draft determination is limited to simply explaining the ATO's view at a theoretical level.

Again, taxpayers have until 31 August 2018 to make a submission on this draft determination.

Draft practical compliance approach to cross-border related party financing arrangements and derivatives

Draft Schedule 2 of *Practical Compliance Guideline PCG 2017/4* is a substantial 14 page addition to the already weighty guidance on the ATO's compliance approach to cross-border related party financing arrangements and related transactions.

This latest update deals with the *'related transactions'* element of the title of the PCG - covering related party derivative arrangements. Whilst the main body of the PCG suggests that the scope of the guideline is limited to only transactions which are related to cross-border financing arrangements, the draft Schedule itself does not seem to be so limited.

It is possible that the draft Schedule could be interpreted so that non-financing related derivative arrangements are within its ambit - indeed some of the risk indicators and examples (e.g. dealing with total return swaps) noted in it may suggest that this broad interpretation is intended.

The draft Schedule itself is structured similarly to the first schedule of the PCG, with taxpayers self-assessing against a series of risk indicators providing an overall score which will then determine the

relevant risk zone. The risk assessment is done on a transaction basis, with the entity's risk zone being determined by reference to the transaction with the highest score.

Unlike Schedule 1 of the PCG, the risk indicators proposed in Schedule 2 are binary yes or no answers. Most of the indicators are 'motivational' in nature, with only one of the indicators referencing the pricing of the derivative arrangement.

This 'motivational' approach is consistent with the scope of the Schedule which considers the risk of an arrangement by reference to:

- deductibility of payments
- liability to withholding tax
- the application of the transfer pricing rules, and
- the application of the general anti-avoidance provisions (Part IVA) to schemes which are confined to such arrangements.

It appears that concerns over deductibility, withholding tax and Part IVA take primacy over transfer pricing concerns.

The weighting of the risk indicators means that almost any related party derivative that is not precisely matched (under back-to-back terms) to a third party derivative will be placed in the 'very high risk zone'. This ATO compliance approach is not surprising because the ATO flagged concerns in relation to related party cross currency swaps in April 2016 (refer *Taxpayer Alert TA 2016/3: Arrangements involving related party foreign currency denominated finance with related party cross currency interest rate swaps*).

Taxpayers have until 31 August 2018 to provide comments on this Schedule.

The takeaway

The ATO has an unrelenting focus on all aspects of cross-border financing and related transactions and this new draft guidance is a continuation of this theme.

Taxpayers should closely examine all aspects of their capital structure in light of the ATO's focus. Based on the guidance issued this week, taxpayers who have:

- debt interests which are not wholly classified as liabilities for accounting purposes
- debt interests which are not included in debt capital because no debt deductions have been claimed in relation to them; and / or
- any derivatives with related parties,

should closely examine how these arrangements have been treated in light of the ATO's guidance.

Affected taxpayers should also consider making a submission in relation to the draft guidance. Submissions on all three documents are due by 31 August 2018.

Let's talk

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