PCG 2019/D3 – A way forward on the Arm's Length Debt Test

3 September 2019 *Explore more insights*

In brief

On 28 August 2019 the ATO released draft Practical Compliance Guideline PCG 2019/D3 (the **Draft PCG**), which sets out the Australian Taxation Office's (**ATO**) views on practical aspects of the Arm's Length Debt Test (ALDT) which is relevant for thin capitalisation purposes. The release of the Draft PCG follows release of draft Taxation Ruling TR 2019/D2 (the **Draft Ruling**) which provided the Commissioner of Taxation's views on key technical aspects of the ALDT (TR 2019/D2 is the subject of a previous *TaxTalk* – Insights article dated 8 April 2019). It is intended that once finalised, the Draft Ruling accompanied by the Draft PCG will replace the only other earlier guidance on the ALDT issued by the ATO in 2003 (TR 2003/1).

The Draft PCG and Draft Ruling together replace the six-step methodology suggested in TR 2003/1, which has formed the basis for the ALDT analysis undertaken by many taxpayers to date. The Draft PCG emphasises the clear distinction between the independent lender test (what *could* you borrow) and the independent borrower test (what *would* you borrow). It provides guidance on how to have regard to the factual assumptions and relevant factors of the 'notional standalone Australian business' in order to calculate the maximum allowable debt (read: commercially supportable debt quantum). The 'notional Australian standalone business' is a hypothetical construct, which comprises the taxpayer's Australian commercial activities, disregarding any foreign interests, associate entity debt, and the provision of credit support.

The Draft PCG sets out what the Commissioner considers to be a reasonable approach to undertaking the ALDT and establishes a series of considerations which taxpayers should avail themselves of in performing self-assessment. The Draft PCG sets out a level of analysis that represents the "minimum standard expected of a comprehensive and robust ALDT analysis".[1] The ATO is of the view that Australian businesses are not commonly geared in excess of the safe harbour debt amount, and therefore the 'choice' to apply the ALDT carries the weight of undertaking a more robust analysis to demonstrate the commerciality of the quantum of debt capital in the entity as the maximum allowable debt under Australia's thin capitalisation provisions.

In detail

Similar to earlier PCGs on other matters, the ATO expects taxpayers to self-assess their risk zone with respect to the ALDT. There are essentially two risk zones contained in the Draft PCG, being Low Risk (Green) and Medium-High Risk (Yellow). The criteria for being in each zone varies depending on whether the business is regulated or non-regulated, inbound or outbound and whether the actual debt comes from related parties or third parties. It is likely that the majority of the taxpayers will fall in the Medium-High Risk zone, which means that the ATO may apply compliance resources to review the debt capital supported under the ALDT.

There is also a White Zone for arrangements where the ATO has already undertaken a review (where the review commenced after 1 July 2019) and concluded on the outcome. For White Zone arrangements, the ATO will not review these arrangements further, other than to confirm ongoing consistency with the agreed/determined approach.

[1] PCG 2019/D3 paragraph 14.

The Draft PCG is extensive and includes commentary on many of the practical aspects of the arm's length debt analysis. This document does not deal with all aspects of the Draft PCG however some of the notable points are set out below.

1. **Financial data:** In defining the financial position of the Australian business, accounting information used in preparation of the tax return is seen as the starting point. The ATO expects to see a reconciliation of financial information to statutory accounts. However, the relevant value of assets used in the analysis can depart from accounting values provided appropriate evidence is maintained. For example, in the case of regulated entities, regulated asset base might be considered appropriate.
2. **Comparables:** Selection and use of comparables are important in both the borrower and lender tests. The comparables used in the analysis need to reflect independent companies and should ideally be in the Australian market and the process of selection needs to be supported with a detailed analysis. Where it can be demonstrated that no suitable comparable exist in the Australian market, other geographic markets can be considered. However, the ATO has observed that for regulated industries, overseas regulated markets are not considered comparable. The ATO has also provided guidance on how it expects the comparable analysis to be used in assuming an arm's length debt amount.
3. **Relevance of transfer pricing analysis:** In considering the requirement to ensure that the debt is on terms and conditions that would reasonably be expected at arm's length, it is not acceptable to assume that an analysis undertaken for transfer pricing purposes is sufficient. The ATO observes that taxpayers may adopt a 'conservative' position for transfer pricing purposes (i.e. a lower interest rate). Where this is the case an adjustment needs to be made for the interest that might be expected at arm's length (having regard to the statutory assumptions).
4. **Use of credit rating approaches:** Using the published guidance of rating agencies can be useful provided they are applied in an appropriate way. For example, credit ratings can be useful to identify a consistent set of limits or covenants ranges. Credit ratings or agency rating reports can be useful in weightings applied to the relevant factors (from a lender test perspective).
5. **Covenants**: Any covenants should reflect those that the notional Australian business would reasonably be expected to agree to. Where actual covenants exist in third party debt that provide a basis to test debt serviceability these need to be considered. The existence of actual covenants cannot be ignored - adjustments must be made if departing from actual covenants due to consideration of the statutory assumptions. In applying the covenants the ATO expects that consideration is given to the headroom that would be expected, i.e. the covenant limits do not define the amount that the borrower would be expected to have.
6. **Consideration of relevant factors**: All of the statutory relevant factors must be considered in applying the test. It is acknowledged though that some factors will have greater or lesser significance on the outcome than others. For qualitative factors, the ATO has proposed a structure which weights each factor as "Supportive", "Neutral" or "Adverse". It is noted that consideration of how these assessments impact on the quantitative measures requires an exercise of judgement.
7. **Weighting of metrics:** In applying quantitative metrics (ratios such as Interest Cover Ratio, Return on Capital Employed, etc.) to the analysis the ATO suggests that in circumstances where multiple metrics are being considered, a weighting should be determined (with appropriate support and evidence). For administrative ease, the ATO accepts that taxpayers may adopt equal weightings.
8. **Return on capital:** An important factor in the borrower amount is the return on capital. The 'return' can be in the relevant year or at any other time. Where negative equity exists it is acceptable to explain by way of undervaluation of Australian assets and to use revalued amounts for comparison purposes. After tax profit and cash flow measures need to be considered. Return on equity capital should exceed the required rate of return (hurdle rate). The ATO suggests using a capital asset pricing model approach as a way of testing this aspect.

9. **Management's financial risk appetite**: The ATO's view is that the functional analysis should have no regard to the financial risk preferences of the entity. Note this view will have particular significance from the borrower perspective in circumstances where the leverage of the entity is high relative to others in the industry that might have a more conservative financial risk preference (for example, listed companies as opposed to private companies).

The ATO postulates that, "there are limited circumstances in which an entity would gear in excess of 60% of its net assets" and "in most circumstances … do not consider the ALDT will enable an entity to achieve maximum allowable debt in excess of the safe harbour debt amount".[2] However, the ATO does recognise that the ALDT is "more likely to be relied upon in an industry where it is common practice to operate with higher debt to equity ratios".[3] The application of the thin capitalisation rules does not prevent the Australian business from assuming higher levels of debt, however, the debt deductions will be denied where the statutory limits are exceeded. On this basis, the evidence required to satisfy the non-statutory framework contained within the Draft PCG to support a commercially supportable level of debt if a taxpayer does not fall into the limited "low risk" outcomes is increasingly onerous.

The date of effect of the Draft PCG is 1 July 2019 and will apply where the ALDT has been used to establish an entity's maximum allowable debt from this date. The date of effect of the Draft Ruling is when the final ruling is issued, and is proposed to apply both before and after its date of issue.

Consultation on the Draft PCG is open until 9 October 2019, with the final version anticipated to be delivered in early 2020.

The takeaway

The picture that emerges from the Draft Ruling and Draft PCG is that, in the Commissioner's view, while Australia's thin capitalisation legislation itself has not changed, the evidence and analysis required to discharge the onus of proof for the taxpayer that it has satisfied the key legislative requirements of the ALDT has significantly increased.

While the Draft PCG provides further clarity as to the Commissioner's recommended approach for undertaking an ALDT analysis that was not provided in the Draft Ruling, given that any analysis is based on the facts and circumstances of each case, there will inherently remain various issues and considerations which would need to be addressed given the circumstances of the taxpayer. Nevertheless, the PCG product does provide a broad framework around how to consider these specific issues and considerations, which is positive.

Following release of the Draft PCG's practical framework, taxpayers should evaluate their go-forward ALDT positions against Australia's thin capitalisation legislation and the ATO's compliance approach to consider whether achieving a "low risk" outcome is feasible. In the absence of achieving a "low risk" outcome, taxpayers are encouraged to assess the overall commerciality of the capital structure of their Australian business having regard to the relevant factors contained in Australia's thin capitalisation legislation against the Draft PCG.

Irrespective of the views of taxpayers and advisers on the Draft Ruling and Draft PCG, it remains imperative for taxpayers to robustly document technical positions adopted in respect of their capital structure, and to overlay those positions with detailed consideration of the commerciality thereof – even for the simplest ALDT exercise. The flavour of the Draft PCG is that commercial lending practices observable in your industry take centre stage, which will likely necessitate a closer relationship between taxpayers' tax and finance / treasury teams and their financiers.

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[2] PCG 2019/D3 paragraph 11.

[3] PCG 2019/D3 paragraph 12.

Let's talk

For a deeper discussion of how these issues might affect your business, please contact:

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