ATO continues to finalise views on cross-border debt issues

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In brief

The Australian Taxation Office (ATO) continues to finalise its guidance on aspects of cross-border financing. However, for many taxpayers, this latest guidance may raise more questions than it answers.

Over the last two weeks, the ATO has released the following Tax Determinations that deal with aspects of cross-border financing:

- TD 2019/10 - Income tax: can the debt and equity rules in Division 974 of the Income Tax Assessment Act 1997 limit the operation of the transfer pricing rules in Subdivision 815-B of the Income Tax Assessment Act 1997?; and

- TD 2019/12 - 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?

These determinations where previously released in draft form as TD 2018/D6 and TD 2018/D5 respectively and the draft determinations were discussed in our prior TaxTalk Alerts on 30 November 2018 and 1 August 2018.

The final determinations are extremely similar to the two drafts, and therefore many of the same questions remain. Further, some of the changes made to finalise these determinations arguably give rise to additional uncertainty.

The one absolute certainty demonstrated by the release of the two finalised determinations is that the ATO will continue to have an intense focus on cross-border financing.

In detail

The interaction of the debt equity rules and the transfer pricing rules

The finalised TD 2019/10 is substantially unchanged from the draft determination - with the explanation for the lack of changes set out in a compendium available on the ATO's website.

The lack of changes from the draft determination mean that many of the issues raised in our earlier alert continue to be relevant, including the lack of clarity as to:

- how to identify the 'arm's length conditions' for the purposes of Subdivision 815-B, particularly as they relate to the debt-equity rules;

- when transfer pricing adjustments which alter the debt-equity classification of an instrument can occur under section 815-115 versus where those adjustments amount to a reconstruction under section 815-130; and

- other interactions arising from the transfer pricing provisions' altering the debt-equity classification of instruments

which continue to be areas of uncertainty for taxpayers and advisers.

One of the most consequential changes from the Draft Determination to the Final Determination actually exacerbates the uncertainty regarding the other interactions arising from the change in classification of an instrument, particularly the consequential adjustment provisions.

This is particularly highlighted through Example 2, which deals with an inbound discretionary interest loan.

In this example in the Draft Determination, it was noted that based on its terms the loan *"would satisfy the equity test"* and *"[a]ny interest paid… would constitute a non-share dividend and may be subject to dividend withholding tax."* The Draft Determination considered that the arm's length conditions would actually result in an interest bearing loan that would be a debt interest for tax purposes and therefore that *"Australian Company therefore gets a transfer pricing benefit equal to the full amount of the interest withholding tax that would be payable had the arm's length conditions operated"*.

Finally, the Draft Determination commented that:

"To the extent Australian Company would have received an allowable deduction for interest it is taken to have paid under arm's length conditions, the Commissioner may make a determination to adjust Australian Company's taxable income or loss, provided the relevant conditions are satisfied."

Essentially the Draft Determination made three propositions in respect of this example:

1. That dividend withholding tax may have applied based on the actual conditions;

2. That section 815-115 would operate so that there is a transfer pricing benefit equal to the amount of interest withholding tax that would have been payable under the purported arm's length conditions; and

3. That the Commissioner may make a consequential adjustment under section 815-145 to allow for an interest deduction that would be available based on the purported arm's length conditions.

If the Determination's conclusion that the substitution of actual arm's length conditions should result in the reclassification of the instrument is correct, then the second and third propositions are seemingly uncontroversial. Though it does represent a change in approach for the ATO, as earlier guidance in TR 2007/1, albeit dealing with the former transfer pricing provisions in Division 13 rather than Subdivision 815-B, suggested that it would not ordinarily be appropriate to make a transfer pricing adjustment for interest free loans to resident entities.

However, the first proposition could be of some concern for taxpayers, as the operation of section 815-145 does not appear to extend to provide for a consequential adjustment where dividend withholding tax had erroneously been paid. This is confirmed in the Item 12 of the ATO's Compendium.

In any case, Example 2 is ***significantly*** adjusted in the Final Determination. The facts of Example 2 are changed in the Final Determination by the addition of an extra sentence:

"Australian Company uses the funds in its offshore permanent establishment which returns income that is non-assessable, non-exempt income in accordance with section 23AH of the ITAA 1936."

The rest of the example continues unchanged, with the exception that there is now no mention of a potential consequential adjustment for the Australian Company in the event that the arm's length conditions were substituted, presumably due to the change in facts.

The change in the facts in Example 2 is disappointing as it has meant that the example is less relevant to most taxpayers (i.e. the population of taxpayers borrowing in Australia for use in foreign permanent establishments is presumably smaller than the population of taxpayers borrowing in Australia more generally). It also means that the Commissioner now provides no guidance at all on consequential adjustments in the Final Determination.

In addition, the change in facts is also somewhat confusing. Generally, interest which is an outgoing wholly incurred in carrying on business outside Australia at or through a permanent establishment would not be subject to interest withholding tax - meaning that there would be no transfer pricing benefit. The Final Determination does not grapple with this outcome of the factual change.

Ultimately, the Final Determination makes it clear that the ATO will seek to apply the transfer pricing provisions to adjust the conditions of financing arrangements, and that these adjustments can result in a change in debt-equity classifications. This is an area of considerable uncertainty for taxpayers and the impact of tax on their Australian businesses.

The result of this ATO focus is that taxpayers and advisers will need to ensure that their transfer pricing analysis supports the arm's length nature of all material conditions of cross-border related financing, and not just consider the price of the relevant instrument.

The meaning of debt deduction for thin capitalisation purposes

Final tax determination TD 2019/12 intends to define the meaning of debt deduction for thin capitalisation purposes.

The classification of a cost as a debt deduction is important for at least two key reasons:

1. Amounts which are debt deductions may be denied a deduction where an entity breaches thin capitalisation limits; and

2. An entity must include in its adjusted average debt (an integer in the thin capitalisation calculations) all of its debt capital that gives rise to debt deductions.

Based on its first paragraph, TD 2019/12 seems to be principally concerned with the second outcome set out above. That is, the ATO appears to be focussed on ensuring that debt capital which may not otherwise be included in an entity's adjusted average debt (for example, because no dividends have yet been paid on mandatorily redeemable preference shares per the Example in the determination).

As set out in our original TaxTalk Alert, the key information contained in the predecessor Draft Determination (beyond what is available either in the legislation or explanatory memorandum) was the ATO's view that:

"tax advisory costs incurred in relation to the debt capital, which relate to activities including, but not limited to, agreement drafting and valuation of the debt capital"

could be debt deductions for thin capitalisation purposes. All of the other specific items mentioned in the Draft Determination are covered by extrinsic materials.

There are four major changes from the Draft Determination to the final TD 2019/12:

1. the explicit inclusion of *"any costs considered to be borrowing expenses under section 25-25 of the ITAA 1997 or former section 67 of the Income Tax Assessment Act 1936 (ITAA 1936)"* in the list of items which are debt deductions in paragraph 3 of the Final Determination;

2. the inclusion of a footnote (likely in response to submissions) clarifying the Commissioner's view that tax advice does not include *"costs of accounting for the debt capital on an ongoing basis, tax return preparation costs, and other post implementation business costs that do not directly relate to the maintenance of the finance"* and hence are not considered to be debt deductions;

3. the deletion of *"[s]ection 25-25 borrowing expenses are not costs of the type described in subparagraphs 820-40(1)(a)(i) and (ii)"* from the Final Determination; and

4. the inclusion of a concluding paragraph which states that *"the Commissioner considers that the underlying principle is a factual enquiry into whether the cost or costs, relevantly apportioned, has a close and direct connection with the objects of the expenditure – which can be either obtaining or maintaining the financial benefits received, or to be received. Accordingly, the same type of cost might be said to be debt deductions for one entity under the subparagraph, but not for another entity. This is so because the relevant factual enquiry is based on the entity's specific facts and circumstances."*

Based on TD 2019/12, determining the extent of debt interests that should be included in the adjusted average debt balance of taxpayers is clearly a priority of the Commissioner. Moreover, the changes from the Draft Determination to the Final Determination suggest a potential evolution of the Commissioner's views in respect of borrowing costs.

The takeaway

TD 2019/10 and TD 2019/12 represent a continuation of the ATO's focus on cross-border financing.

Because of the views in TD 2019/10, taxpayers will need to carefully consider the arm's length nature of all conditions of their cross-border related party financing (and not just pricing conditions), particularly for any arrangements that have less common features.

The conclusions reached in TD 2019/12 mean that any taxpayers who have any amounts which are classified as debt for tax purposes, but which are not included in their adjusted average debt for thin capitalisation purposes on the basis that it is not debt capital which gives rise to debt deductions, should carefully consider what, if any, deductible costs may relate to those instruments.

Ultimately both determinations emphasise the need for careful consideration of the tax consequences of all cross border related party financing.

Let's talk

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

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