TR 2019/D2 - An ATO refresher on the Arm's Length Debt Test

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In brief

On 5 April 2019, the Australian Taxation Office (ATO) released draft Taxation Ruling TR 2019/D2 (the 'Draft Ruling') which provides the Commissioner of Taxation's views on key technical aspects of the Arm's Length Debt Test (ALDT) which is relevant for thin capitalisation purposes. The Draft Ruling, which is proposed to apply retrospectively, will be followed by a Practical Compliance Guideline (PCG) which will provide guidance on the practical application of the test. It is intended that once finalised, the Draft Ruling accompanied by the PCG will replace the only other previously issued guidance on the ALDT issued by the ATO in 2003 (TR 2003/1).

The Draft Ruling (along with the anticipated PCG) is welcomed as taxpayer reliance on the ALDT continues to increase as business models and debt markets evolve which lend themselves to gearing levels which do not always fit within the more common 1.5:1 debt/equity safe harbour. While it does clarify and confirm some points for interpretation which are likely to have broader consensus within the taxpayer community, there are aspects of the Draft Ruling which may potentially result in a divergence in views and positions undertaken by taxpayers in previous ALDTs, as well as a number of key issues which are not addressed.

While more practical guidance is expected to be released in due course, taxpayers should evaluate their historic ALDT positions in light of the Draft Ruling and understand how the result may play out under this guidance.

Ultimately, and going to the practical heart of the Draft Ruling, is the fact that the ALDT is now a key focus area of the Commissioner and each case is likely to come down to an evidentiary exercise between taxpayers and the Commissioner as to whose view is more "reasonable".

In detail

Background to the Draft Ruling

Once finalised, the Draft Ruling will apply retrospectively to non-ADI entities and will replace the existing taxation ruling on the application of the arm's length debt test (TR 2003/1). It will be supplemented by a PCG which is anticipated to provide practical guidance in application of the test. The six-step methodology proposed under TR 2003/1 will not be replicated under the new guidance.

The format of the Draft Ruling is such that it provides guidance around what the Commissioner considers to be a number of key technical issues with respect to the ALDT. A summary of these points (along with relevant observations) has been provided below.

Overview of technical issues within the Draft Ruling

- **The two limbs of the ALDT -** The ALDT requires the separate quantification of a debt amount under both the independent borrower test (the "*would you borrow"* test) and the independent lender test (the "*could you borrow"* test). The Commissioner confirms that these are different tests due to the perspective and lens applied, as while the borrower may have the capacity to take on additional debt from a lender who is willing to provide debt financing, one must not automatically assume that the borrower would draw down on the funds unless it makes commercial sense. As these are independent tests, and given that the determined Arm's Length Debt Amount (ALDA) needs to satisfy both tests, the concluded ALDA is that determined as the lower of these two tests.

  Observations: The approach is consistent with the understanding for the need to separately consider the ALDA from the perspective of the hypothetical lender and borrower. The Draft Ruling intends to flag a key risk area from the Commissioner's point of view, being that some ALDTs may over-emphasise and merely conclude on the amount of debt an entity "could" borrow, without due regard to whether the borrower "would" draw down on the financing given its specific circumstances.

- **The ALDA is what "would reasonably be expected" -** The key aspect around determining the ALDA is the amount of debt which *"would reasonably be expected"*. This is in contrast to the "maximum" amount of debt an entity could and would borrow. The Draft Ruling emphasises through reference to case law that what "*would reasonably be expected"* is based on an objective assessment and goes beyond a mere possibility but rather is based on an expectation, or a sufficiently reliable prediction of the expected outcome, which needs to be based on detailed evidence.

  Observations: While the "reasonableness" test was also covered in TR 2003/1, this is a key technical and legal aspect in application of the ALDT, and a point of focus for the Commissioner. While this test is incorporated across both limbs of the ALDT, generally speaking, the reasonableness test significantly impacts the "independent borrower" limb of the ALDT. Specifically, the onus continues to be on the taxpayer to demonstrate that even though the Australian business had the possibility of a range of borrowing scenarios and outcomes, that the proposed amount of debt is what *"would reasonably be expected"* if it was drawn from a third party.

  Based on experience, this requires detailed analysis and presentation of evidence, as the Commissioner focuses on the options available to the borrower and the optimal capital structure for the Australian business.

- **The ALDT is an annual test** - Under the legislation, the ALDT is to be performed on an annual basis. Notwithstanding, where a taxpayer has not raised debt in the income year in question, the Commissioner states in the Draft Ruling that there is an explicit requirement to consider the circumstances in the income year in which the last debt instrument was entered into. To the extent that there subsequently has not been a significant change in the key factors evaluated under the ALDT, the analysis at the time this last debt was entered into remains relevant for the current year. Even in such cases, annual testing remains a strict requirement as it could be the case that the very same debt which was supportable in one income year may not be supported in subsequent periods.

  Observations: While there is no contention that the ALDT is an annual test, there is an interesting practical consideration for taxpayers who have not entered into any new debt interests within the current income year being subject to the test. Specifically, assuming that the debt was supportable through the ALDT in the income year in which it was entered into, what is the Commissioner's expectation around the type of analysis and amount of work required to demonstrate that the facts and circumstances in the current year and the year in which the entity last raised debt are sufficiently similar? What level of work is required to satisfy both the borrower and lender tests if no new debt has been assumed for the year? Will this be focused on the options available to both the borrower and lender under the assumption that the debt has been on foot from a prior year?

- **The focus of the ALDT is on the "Australian business" -** The law requires that the ALDT is focused on the construct of the hypothetical "Australian business". The Draft Ruling summarises the definition of the "Australian business" and what needs to be carved out separately for inward and outward investing entities. In the Draft Ruling, the Commissioner confirms that:
  - any related party transactions not connected with the holding of debt and equity are considered in identifying the Australian business as long as they relate to Australian activities (e.g. management fees, royalties etc.)
  - Whilst dividends or interest received from holdings of controlled foreign equity and debt respectively are carved out, the resulting accumulated cash from such payments is considered (as an asset) of the Australian business.

  Observations: This provides additional clarity around the adjustments required to identify the Australian business, although there is some ambiguity around the issue of cash balances. For example, it is unclear whether this refers only to cash balances from previous year distributions/interest payments or whether any cash from distributions/interest payments in the year being tested should be accounted for in the Australian business.

- **Can the nature and objectives of the shareholders of the entity be taken into account in applying the test?** The Draft Ruling emphasises that the two limbs of the ALDT should be applied to a hypothetical Australian business with the same operational, financial and business attributes in the context of which it was actually carried on throughout the year. As an extension to this concept, the Commissioner contends that there is no role within the ALDT to consider the foreign operations outside of the Australian business, and more specifically, the strategic objectives and investment strategies of the shareholders of the tested taxpayer when identifying the facts and circumstances associated with the Australian business. The Commissioner bases this on the view that while the hypothetical Australian business is considered to have its actual management team, its policies and decisions must not reflect the shareholders' subjective preferences on operating and capital management strategy, as the ALDT is based on an objective test of what 'would reasonably be expected'.

  Observations: This is an area of interpretation which will create divergence of views. Notably, the Commissioner's conclusion is based on the fact that the legislation directs attention to the *operations* of the entity and neither the law or the Explanatory Memorandum to the Bill that introduced the ALDT refer to the entities' shareholders. Such a lack of reference, however, could well support the opposite conclusion in the context of the legislative provisions, which specifically list the characteristics and facts to be explicitly disregarded in identifying the hypothetical Australian business of the entity (i.e. associated entity debt, controlled foreign equity and debt, implicit and explicit credit support, the income from foreign assets/operations etc.), thereby suggesting that absent explicit exclusion of the circumstances connected to the shareholders, one would consider these to be factored into the analysis.

  This proposition is also supported by some of the relevant factors listed in sections 820-105(3) and 820-215(3), which include the need to directly or indirectly consider factors such as:
  - the profits and return on capital of the entity (which are measures inherently relevant to the shareholders)
  - the risks assumed by the entity
  - the purpose of the debt capital
  - the commercial practices in the industry

  It would be difficult to consider any of the above points for the Australian business without understanding or taking into account the constituency and preferences of its shareholders. Said another way, one may find it difficult to reconcile how the objectives of shareholders cannot be taken into account and divorced from the management policies of the Australian entity, which need to be taken into account. Using the Commissioner's example in paragraph 56 of the Draft Ruling, the operational changes undertaken by the Australian business are almost always based on the investment mandate and business considerations of its shareholders. Should these preferences simply be ignored or should they be replaced with other preferences? If they are to be

replaced under the objective standard, how does one determine what would be the "objective" preferences of the Australian management team? As a very simple example, the investment and capital management strategy of two businesses (which perform identical business operations) would significantly differ if one was publicly listed, while the other was owned by private equity.

- **Values to be used in applying the ALDT -** Similar to TR 2003/1, the Draft Ruling recognises the relevance of commercial practices in the industry to determine the value of assets and liabilities of the Australian business for the purposes of applying the ALDT. Furthermore, it confirms that such values could potentially differ from values determined for accounting purposes, and the latter may be disregarded if it is demonstrated that lending and borrowing practices in the industry are based on different metrics.

  Observations: This approach which seeks to replicate market economic practice (as opposed to being tied to accounting standards) is considered reasonable and should result in a commercial approach when applying the ALDT. Of importance to note is that often there is no "one size fits all" approach to any industry - as an example, traditional bank lenders may be more focused on security value whilst subordinated alternative lenders may be more focused on cash flow and servicing metrics.

- **Broadening the definition of commercial lending institutions -** In determining how much a "commercial lending institution" could lend, the Draft Ruling confirms that such institutions are assumed to have a broad meaning, limited to not just banks and ADIs, but other markets whose commercial activities extend to the provision of debt capital.

  Observations: This is a sensible approach and correctly allows other forms of non-bank lenders and institutions that provide debt capital on commercial terms to be considered, depending on the observable lending practices in the industry.

- **The need to disregard implicit and explicit credit support -** The Commissioner confirms that the law requires that the hypothetical Australian business is assumed to borrow on a standalone basis, i.e. without any form of credit support, whether it be explicit (such as financial guarantees) or implicit (such as implicit support or non-binding comfort letters).

  Observations: This approach would broadly align with commonly accepted practice with current ALDTs. The Draft Ruling, however, does not provide any examples of how to practically deal with credit support when this is an inherent feature of the business model of the borrower (for example in project finance, where the use of security arrangements or cross guarantees by the project obligors is very common and which may, in isolation, increase the amount of finance that can be raised).

- **Weighting given to each of the 'relevant factors' -** The Commissioner confirms that whilst all the relevant factors in sections 820-105(3) and 820-215(3) must be considered in performing an ALDT, in practice the weight each factor is given in an analysis could vary based on the circumstances of the Australian business, the debt capital assumed, evidence of approaches taken by external lenders and credit rating agencies etc.

  Observations: While the weighting of different relevant factors is consistent with the general approach taken in performing ALDTs, it will be important for taxpayers to provide objective reference points and evidence around why specific factors are more relevant than others. This will need to be covered in detail within the ALDT report. Given the sensitivity of ALDT analyses to the relevant factors, it would be helpful if in the final Ruling the ATO provide examples of the application and weighting of the relevant factors in an analysis.

- **Measurement points -** The Commissioner states that in accordance with legislation there is a need to determine the ALDA "*throughout the income year*". This requirement differs to calculating average

values under Subdivision 820-G, and the approach undertaken will depend on the facts and circumstances of the nature of the Australian business and the associated debt.

Observations: In cases of material changes to the Australian business and the nature of the debt capital throughout the income year, multiple ALDAs may need to be determined and averaged. The question of the extent of the degree of change that is required to warrant such an approach is not clear cut and will be dependent on commercial practices adopted by independent lenders and borrowers in the industry. Where such an approach is warranted, this may potentially result in a significant compliance burden for taxpayers.

- **The use of historic and forecast data** - Depending on the commercial practices in the industry and the facts and circumstances of the borrower, historical and forecast data and financial information of the Australian business could be considered in performing the ALDT.

  Observations: This approach is considered reasonable as it is consistent with common market practice for borrowers and lenders.

- **Documentation requirements** - The Commissioner confirms that documentation supporting the calculation of the ALDA should be prepared by the time by which the entity must lodge its income tax return for the relevant income year. This documentation should contain an analysis of the ALDT, including the factual assumptions and relevant factors that have been considered in arriving at the ALDA. The lack of such documentation could result in administrative penalties for the taxpayer. Importantly however, not preparing the required documentation by the due date of the tax return would not preclude the possibility to rely on the ALDT for the income year in question.

  Observations: While this clarification is welcomed, in practice it would be recommended for taxpayers to undertake a detailed analysis prior to the filing of the tax return in order to ascertain the ability to rely on the ALDT.

- **Interaction with transfer pricing rules** - The Draft Ruling confirms that the hypothetical construct of the "Australian business" under the ALDT differs to the actual borrowing entity, and therefore, there may be a variance in the results when evaluating the result of the capital structure for thin capitalisation and Australian transfer pricing purposes. As an example, a key difference is observed in the statutory framework of the ALDT compared to Australian transfer pricing provisions, being the requirement to disregard any guarantees, security or other form of credit support in identifying the standalone Australian business within the former.

  Observations: This may lead to some interesting (and often at times unintended) results. As an example, assume a scenario in which a related party loan is "under-priced" as the taxpayer has looked to achieve a "green zone" risk rating for Australian transfer pricing purposes with reference to Schedule 1 of PCG 2017/4 (cross-border related party debt financing). Under this scenario, the rate applied is potentially lower than an arm's length rate of interest, and therefore under the ALDT, this rate would need to be increased when modelling the amount of debt under both the lender and borrower tests. The practical implication is that, all things being equal, the ALDA decreases with an increased rate of interest, being an amount which is currently not being claimed as a deduction as a lower rate has been assumed for transfer pricing purposes.

The takeaway

The ATO has sought to provide its views on specific technical aspects of the ALDT for the first time since its initial ruling in 2003. While this is welcomed and does clarify and confirm some points for interpretation which are likely to have broader consensus within the taxpayer community, there are some aspects of the Draft Ruling which may potentially result in a divergence in views and positions undertaken by taxpayers in previous applications of the ALDT.

While practical guidance is expected to be released in due course, taxpayers should evaluate their historic ALDT positions in light of the Draft Ruling and understand how the result may play out under this guidance. Similarly, taxpayers looking to rely on the ALDT for current and/or future financial years would also need to consider the ongoing implications.

Finally, in considering the above, it should be noted that there may be potential changes to Australia's thin capitalisation rules in the event of the election of a Labor government in this year's federal election. Although the detail of any possible proposed changes is not yet known, it may potentially result in increased reliance and relevance of the ALDT as one of the tools available for thin capitalisation purposes, whichever form this may take. If this is the eventual outcome, there will no doubt be an increased desire for further clarification and certainty around the points raised within the Draft Ruling.

Let's talk

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