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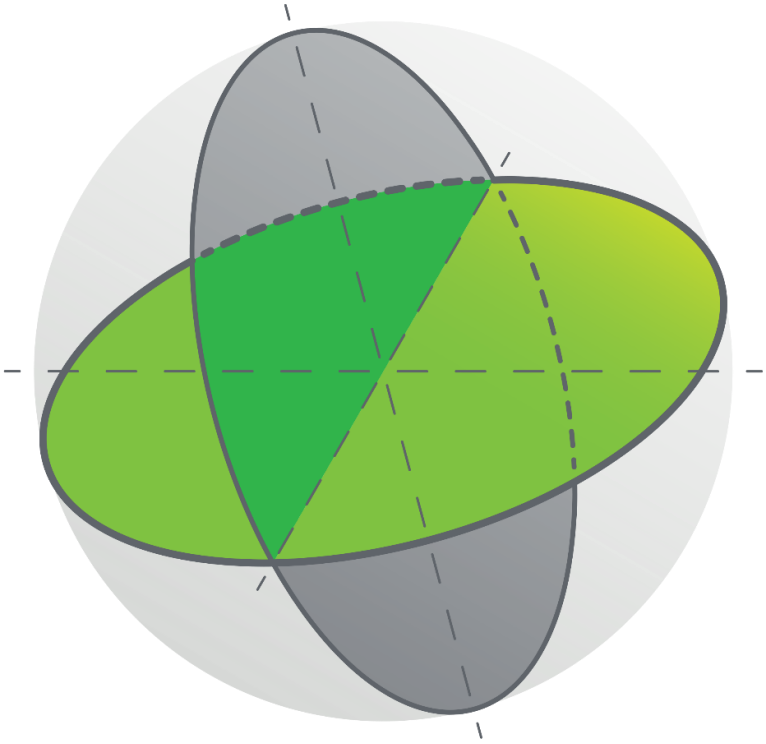

Tax Insights

How are you funding your business?

Snapshot

Managing risk associated with your funding choices

The ATO has had a lot to say in recent months about a range of tax technical issues that impact capital structure, or debt and equity mix, of Australian businesses. The ATO guidance, along with recent law change, may impact the tax outcome of your businesses' financing choices and capital structure. In this environment of new guidance and law change, a number of issues remain uncertain and taxpayers should be reviewing their capital structure to ensure their debt sizing and pricing is adequately considered.

ATO views

In addressing such matters in the current year, Australian businesses should consider the following issues in relation to thin capitalisation:

- Costs that are debt deductions (TD 2019/12)

This Tax Determination (TD) focuses on what constitutes debt capital for thin capitalisation purposes and therefore included in a taxpayer's adjusted average debt for a given income year. The TD addresses what type of costs are considered debt deductions focusing on amounts directly incurred in obtaining or maintaining the financial benefits received, or to be received.

The Commissioner provides a list of examples of such costs including tax advisory fees in connection with debt capital and legal costs of preparing documentation associated with the debt capital. An important consequence of this TD is that a non-interest bearing debt interest will be included in adjusted average debt if relevant advisory fees are incurred.

- **Valuation of debt capital (TD 2018/D4)**

This draft TD followed the release of Taxpayer Alert 2016/9 which highlighted the ATO's focus on arrangements where taxpayers have taken the view that their debt capital for thin capitalisation purposes does not include the value of an instrument to the extent it is treated as equity for accounting purposes. The view expressed in the draft TD seeks to ensure the full value of the instrument is taken into account in determining a taxpayer's debt capital. This scenario can arise, for example, where a financial instrument is bifurcated and treated as both a liability and equity in the accounts (e.g. certain types of mandatorily redeemable preference shares and convertible notes).

- **The removal of 'thin cap only' revaluations (Treasury Laws Amendment (Making Sure Multinationals Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019)**

This Act received Royal Assent in September 2019 and limits the ability of taxpayers to undertake asset revaluations for thin capitalisation only and instead requires taxpayers to rely on asset, liability and equity capital values contained in their financial statements. This change takes effect from 8 May 2018. A transitional measure allows taxpayers who had previously undertaken a revaluation at the time of the Budget announcement in May 2018 to rely on the revaluation until the start of the income year commencing on or after 1 July 2019.

- **New draft guidance on the arm's length debt test (ALDT) (TR 2019/D2 and PCG 2019/D3)**

It has now been a few years since the thin capitalisation rules were tightened with the safe harbour debt test reducing from 75% to 60% on a net asset basis. In 2014 the Board of Taxation recommended that the ATO publish further guidance to assist taxpayers in applying the ALDT. During this time an increasing number of taxpayers have sought to rely on the ALDT and the recent legislative change to remove thin capitalisation only revaluations is expected to see a further increase in the application of the ALDT.

The ATO has now revisited its guidance on the ALDT (currently contained in TR 2003/1) and published a new draft ruling and PCG in 2019. These products are expected to be finalised in the new year and represent a departure from the earlier guidance in terms of the increased expectation placed upon taxpayers to provide robust analysis and evidence to support their application of the test. The draft PCG also provides low risk zones that may apply to a narrow range of taxpayers who fit within the specified facts and circumstances outlined.

Broader context of financing decisions

The recent Glencore decision (*Glencore Investment Pty Ltd* v *Commissioner of Taxation of the Commonwealth of* Australia [2019] FCA 1432) of Davies J in the Federal Court goes to highlighting the ongoing uncertainty in applying the transfer pricing rules and it remains to be seen how the courts will approach an application of Subdivision 815-B. The ATO has recently finalised guidance on the interaction between Subdivision 815-B and Division 974 (TD 2019/10) but the potential scope of reconstruction under the transfer pricing rules, and the ATO's attitude toward reconstruction, remains somewhat unclear.

A theme running through the ATO's draft guidance on the ALDT focuses on the differences between transfer pricing and the ALDT and how the analysis required under each legislative regime whilst similar in some respects, are fundamentally different in other respects.

The above-mentioned matters sit alongside the introduction of BEPS-related measures in earlier years (i.e. Multinational Anti-Avoidance Law, Diverted Profits Tax, Country-by-country reporting, Hybrid mismatch rules and the Multilateral instrument).

A specific rule which is likely to have significant impact on foreign controlled entities is the targeted integrity rule (TIR), which is focused on conduit entity group financing vehicles. The TIR was introduced to prevent the circumvention of the core hybrid mismatch rules by routing finance into Australia via low tax rate jurisdictions. It applies to interest and derivative payments made directly or indirectly to related parties where the payment is taxed at 10% or less, which does not include withholding type taxes. A threshold issue for the TIR is that, broadly, the principal purpose (or one of) of the interposition was the enabling of the low rate foreign tax outcome, and this will be a complicated test to apply in the context of group treasury and cash pooling vehicles for example.

Be prepared for compliance activity

The ATO has indicated the most prevalent issues encountered in streamlined assurance reviews (SARs) relate to cross-border financing (related party financing and thin capitalisation). It is to be expected the ATO will maintain their focus as they finalise remaining SARs, move toward further compliance engagement on taxpayers that have received a low assurance rating or red risk flag and as the program is expanded to a broader range of taxpayers.

We also anticipate renewed attention being directed toward taxpayer’s application of the ALDT in light of the new guidance.

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