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Tax Insights

Thin capitalisation: Arm's length debt test guidance

Snapshot

On 12 August 2020, the ATO published two guidance products in respect of the arm's length debt test (ALDT): TR 2020/4 and PCG 2020/7.

These products are final versions of the draft ruling released in April 2019 (TR 2019/D2) and the draft PCG released in August 2019 (PCG 2019/D3) and as planned, the existing ruling related to the ALDT has been withdrawn (TR 2003/1).

TR 2020/4 – Income tax: thin capitalisation – the arm's length debt test

The final version remains largely unchanged from the earlier draft and therefore retains the focus on articulating the ATO's position on a number of issues where there has been a degree of uncertainty or contention over the years. In particular, the ruling seeks to distinguish the requirements of the ALDT in comparison to the requirements under the transfer pricing rules.

PCG 2020/7 - Arm's length debt test – ATO compliance approach

The draft PCG outlined the ATO's expectations that taxpayers provide robust analysis and evidence to support their application of the ALDT. This theme has remained intact with the release of the final PCG, along with the ATO's detailed guidance on what is considered to be an appropriate approach to an application of the ALDT in practice.

The draft PCG also provided low risk zones that applied to a narrow range of taxpayers that fit within the specified facts patterns. Whilst retaining the low risk zones, a significant addition to the final PCG is the inclusion of a broader range of the now familiar color-coded risk zones.

The start date for application of the PCG is income years commencing **on or after 1 January 2019**.

The new risk assessment framework and some initial observations are discussed in further detail below.

Risk assessment framework

The arm's length debt test risk framework is now made up of five risk zones and is set out below:

Risk zone	Facts and circumstances
White	Arrangements already reviewed and concluded.
Low	Arrangements consistent with low risk zone criteria (paragraphs 30, 32 and 40 of the Guideline).
Low to moderate	Arrangements consistent with low to moderate risk zone criteria (paragraph 45 of the Guideline).
Medium	Arrangements that are not eligible for 'white', 'low' or 'low to moderate' risk zones, facts and circumstances pertaining to the high risk zone are not present and application of the arm's length debt test is consistent with the Guideline.
High	Application of the arm's length debt test that is not consistent with the Guideline, or arrangements that have **two or more** of the following characteristics: • Cross-border related party debt comprises more than 50% of the notional Australian business' debt capital • Subordinated cross-border related party debt comprises more than 25% of the notional Australian business' debt capital • Two years of positive (unadjusted) earnings before interest and tax (EBIT) and negative profit before tax (PBT) during the previous five-year period.

White zone

The final PCG retains the white zone which broadly includes taxpayers who have already had their arrangements reviewed or have otherwise agreed their ALDT outcome with the ATO.

The guidance continues to encourage taxpayers to engage with the ATO in order to seek assurance and this approach may be useful for some taxpayers with particular facts and circumstances. However not all facts and circumstances will be inherently well suited to a white zone engagement process and this should be assessed on a case by case basis. A basic example where engagement may be productive could involve a fact pattern where the taxpayer is reasonably close, but doesn't quite meet, a low or low to moderate risk zone assessment.

In addition to providing certainty to the taxpayer of the ALDT outcome, there is additional benefit resulting from a white zone engagement due to the ongoing reduction in annual documentation to substantiate the taxpayer's ALDT position.

Deloitte comments: **White zone - key takeaways**

Manage risk / administrative benefits - whilst not suitable in all instances, and dependent upon the relevant facts and circumstances of the taxpayer, early engagement *may* be a good option to manage risk and achieve certainty for a taxpayer without significant cost.

Application of the ALDT should be tailored to the taxpayer's facts and circumstances - those circumstances will dictate the information necessary to present to the ATO during a white zone engagement and the areas of risk that need further evidence to demonstrate the taxpayer's gearing is arm's length in accordance with the legislative test.

Potential outcome of white zone engagement - reduced compliance and documentation obligations provided the criteria for the white zone assessment are maintained. Importantly, the taxpayer's circumstances may change in a future year such that the assessment may no longer be relied upon, however falling outside the agreed criteria is not necessarily indicative that the debt levels do not satisfy the ALDT, simply that the streamlined evidentiary process can no longer by relied upon.

Low risk zone (green)

The low risk zones remain largely unchanged and includes three broad scenarios that are summarized below;

Inward low risk zone

The inward low risk zone applies where the following factors are present:

- The entity receives debt funding solely from a commercial lending institution/s that is not an associate of the entity. The entity and the actual lender/s must have been dealing at arm's length with each other in relation to the debt interests such that the debt is considered to be on arm's length terms and conditions or the entity has received part or all of its debt funding on back-to-back terms from an associate
- The entity operates an Australian business only
- The entity is not an associate entity of another Australian entity that is an outward investor, and
- The entity receives no guarantee, security or other form of explicit credit support from an associate.

Outward low risk zone

The outward low risk zone applies where the following factors are present:

- The entity is a widely-held publicly-listed entity on the Australian Securities Exchange
- The entity is an outward investing entity (and not also an inward investing entity), and
- The entity's notional Australian business would have the same issuer credit rating (at the same notch) as the actual entity did in fact have, where the entity's actual rating has been determined by an internationally-recognised credit rating agency and encompasses the entire global group's operations.

Regulated utilities low risk zone

For entities operating a regulated utility business (where at least 70% of its total assets comprise regulated assets) the regulated utilities low risk zone applies where the entity meets the following financial metrics:

- Has a net debt to regulated asset base (RAB) leverage equal to, or less than 70%, during the relevant year, and
- Has a cash flow from operations (CFO) interest cover ratio equal to, or greater than, 2.7 times, during the relevant year.

The ATO considers that the criteria set out in each of the low risk zones represent an appropriate proxy or 'shortcut' method in arriving at an arm's length debt amount. Where a taxpayer meets the criteria for a low risk zone, the taxpayer may self-assess their satisfaction of the zone and document evidence of such and is not required to undertake and document a full assessment of the ALDT in that year.

The ATO notes that further compliance resources are unlikely to be allocated to review the entity's arm's length debt amount other than to confirm the existence of the facts required to satisfy the low risk zone.

Deloitte comments: **Low risk zone- key takeaways**

Inward and outward low risk zones – while the zones appear quite limited in scope, in practice we have seen a number of taxpayers either meet the zone (and therefore significantly reduce their requirement to evidence and document their ALDT position) or come close (which has the benefit of providing some indication of perceived risk and may also assist in focusing the areas in the analysis that should be addressed in a more complete application of the ALDT).

Regulated utilities low risk zone – the specific metrics in this zone are presumably based on the ATO's observations within independent entities in the industry and is an indication of the ATO's perception of risk, it may not be widely relied upon in practice for a number of reasons. As an example, many taxpayers in the industry are already required to engage with the ATO around the time of acquisition in connection with FIRB processes and the increasing expansion of unregulated business within such taxpayers may also be subject to relatively high gearing levels but not within the RAB used in the calculation for the zone.

Low to moderate risk zone (blue)

The low to moderate risk zone takes the circumstances broadly discussed in paragraph 35 of the draft PCG and creates a new zone for taxpayers that satisfy either of the following fact patterns;

- Where the global group is publicly rated on third party debt that is on arm's length terms and conditions and the notional Australian business (NAB) would achieve the same credit rating on the basis of its arm's length debt amount; or

- An inward investing entity is owned by a consortium of foreign investors (each with no more than a 20% direct or indirect interest) and the public credit rating of the entity based on the entity's third party debt (that is on arm's length terms and conditions) is equivalent to the credit rating of the NAB on the basis of its arm's length debt amount; and

- No other facts or circumstances pertaining to the high risk zone are present.

The ATO notes that using "the entity's actual rating to support the arm's length debt amount is not always suitable (that is, the actual credit rating is not necessarily indicative of a reasonable amount of debt so starting from this premise may not be appropriate)". However, in the criteria set for the low to moderate risk zone, the ATO asserts there can be sufficient integrity to ensure an appropriate outcome if the credit rating of the notional Australian business does not slip when related party debt is taken into account.

In this instance, merely meeting the criteria in and of itself is not sufficient and additional evidence will be required to support such an approach including demonstration of consideration of the factual assumptions and relevant factors.

***Deloitte comments*: Low to moderate risk zone -key takeaways**

Related party debt - from one perspective, this zone acts as an invitation to hold related party debt at a level that doesn't move the credit rating rating category (i.e. the same 'notch'), but in practice it is somewhat difficult to manage the outcomes of the quantitative aspects of the credit score on an ongoing basis (particularly as time passes from the date of the formal credit score if the business has experienced a meaningful variation in financial performance).

No other facts and circumstances pertaining to the high risk zone are present – meeting this criteria will result in the taxpayer falling within the low to moderate risk zone however it's not entirely clear whether this requires a rejection of any one of the fact patterns in the high risk zone to be present or if it uses the same approach as the high risk zone (i.e., a requirement to meet 2 of the 3 fact patterns). For example, a taxpayer could possibly have the same credit rating for the global group as for the NAB but have more than 25% subordinated shareholder debt and end up being medium risk or high risk dependent upon whether they went on to apply the ALDT in a manner consistent with the Guideline. Note, it must be the case here that the ATO intends that reference in this zone to the high risk zone circumstances is not intended to preclude a taxpayer satisfying the low to moderate zone because the application of the ALDT is not consistent with the Guideline.

Deloitte comments: **Low to moderate risk zone - key takeaways**

Extent of analysis and documentation - simply meeting the zone criteria is not sufficient for this zone and further analysis is required (i.e., it is noted that all factual assumptions and relevant factors in the legislative test must be considered, including evidence of the reasonableness of the debt amount by reference to independent comparable companies). It is also noted evidence demonstrating that equity returns are adequate is required – in other words, don't forget the borrower's test in subsection (1)(a). However as noted, this particular zone does not expressly state the requirement that the application of the ALDT 'is consistent with this Guideline' so there is an expectation that less can be done (for example, excluding the corroborative analysis using the capital asset pricing model discussed in paragraphs 184 and 198 – 208 of the PCG).

Whilst this zone may not significantly reduce the compliance burden of applying the ALDT it does provide the taxpayer with a reasonable level of comfort as to how the ATO perceives their risk and reduces the chance of a review arising in the first place ('by exception' per paragraph 27).

Medium risk zone (yellow)

The yellow zone now includes 3 criteria. Taxpayers that exhibit the following will be classified under this zone:

- Not eligible for 'white', 'low' or 'low to moderate' risk zones
- Facts and circumstances pertaining to the high risk zone are not present; and
- The taxpayer's application of the ALDT is consistent with the Guideline.

This zone now amounts to a catch-all for any taxpayer that doesn't satisfy the criteria for another zone in the risk assessment framework.

Deloitte comments: **Medium risk zone - key takeaways**

"consistent with this Guideline' – the medium risk zone introduces this requirement, which also appears in the high risk zone. Whilst the PCG is quite prescriptive in some respects, it often outlines the considerations and analysis that should be undertaken to meet the ATO's view of the requirements of the legislative test (but inevitably can't deal to the outcomes of such an analysis to the varying facts and circumstances of every taxpayer).

The PCG does however specify the phrase "consistent with this Guideline" should be taken to mean consistent with the approach and principles outlined in the example set out at paragraphs 185 to 211. However, does the 'approach' outlined in the example mean the precise mechanical method outlined in that example? Arguably it should not, as we would contend that the example used in the PCG is just that, one example of how the test could be applied, and whilst it may be appropriate for a range of situations it doesn't cover the field of all possible and appropriate ways to demonstrate an amount of debt that would reasonably be expected. On this basis, a taxpayer could be consistent with the 'approach and principles' in the PCG without precisely replicating the exact mechanics in the example.

High risk zone (red)

The PCG also introduces a red zone and taxpayers can fall into this new zone by either;

- Not applying the ALDT in a way that is consistent with the Guideline; or
- The taxpayer has an arrangement that exhibits 2 or more of the following characteristics:
  - Cross-border related party debt comprises more than 50% of the NAB debt capital
  - Subordinated cross-border related party debt comprises more than 25% of the NAB debt capital
  - Two years of positive (unadjusted) earnings before interest and tax (EBIT) and negative profit before tax (PBT) during the previous five-year period.
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Deloite comments: **High risk zone- key takeaways**

'consistent with this Guideline' - as noted above, this phrase may be somewhat open to interpretation.

Other high risk facts patterns – we acknowledge that in the context of the ALDT it is difficult to appropriately categorise the risk of all taxpayers given the vast range of facts and circumstances that can arise. A taxpayer may have a reasonable amount of debt under the test but have 100% of debt with a related party given the group has a foreign centralised treasury function that sources all group debt in the market and lends that debt through to Australia (thereby exceeding the 50% limit outlined). And in theory, a taxpayer may source an amount of debt that equates to the ALDA from third parties and any incremental subordinated debt from shareholders is excessive (even if that subordinated debt is less than 25% of the total debt capital as outlined).

In this instance however, given it is necessary for the entity to satisfy 2 of the 3 characteristics to be rated high risk it is perhaps a relatively uncommon situation that high risk will eventuate under this element of the zone especially given the third characteristic, discussed below. Given the consequences of a high risk zone rating – that a review is likely to be commenced as a matter of priority (paragraph 27) – this would appear to be the intent.

Positive EBIT and negative PBT - this criteria specifically deals with a situation where the taxpayer's interest expense pushes it into a loss. On face value, it would be higher risk if the taxpayer were consistently generating trading losses but the zone caters to only the narrow range of profit outcomes noted.

Reportable tax position schedule

It is now apparent the Reportable tax position schedule will be amended, presumably for the 2021 income year, to introduce a question regarding a taxpayer's self-assessed risk zone under PCG 2020/7. If the taxpayer is required to complete the schedule, the PCG notes the taxpayer is not a requirement to self-assess its risk rating, "but if you are unable to (or choose not to) you will also need to disclose this" on the schedule. We can expect the data will be used for case selection in the future.

Final observations

We understand that since release of the draft guidance in 2019 there has been a shift in the market's approach to an application of the ALDT. The finalised guidance, with its continued focus on the legislative test and the requirement for robust analysis and evidence to substantiate an arm's length debt amount, now clearly confirms the ATO expectations in this space. The additional differentiation in the risk assessment framework and inclusion in the Reportable tax position schedule only serves to underscore those expectations.

The number of taxpayers applying, or assessing whether to apply, the ALDT is expected to increase in the current environment.

Taxpayers can no longer rely on 'thin cap only' revaluations to support their safe harbour debt test calculation (refer to Tax Insight – How are you funding your business?) and the current market impact of the Covid-19 pandemic may also increase the number of taxpayers considering a move to the ALDT.

In April this year, the ATO announced guidance on how it will adapt its compliance approach for the ALDT in the current year to assist taxpayers affected by the economic impact of the COVID-19 pandemic (for detail and discussion regarding the ATO's approach refer to Tax Insight – Funding your business in the time of COVID-19).

We recommend that taxpayers already relying on the ALDT assess their current approach to the application of the ALDT in light of the finalised guidance and consider their position under the new risk assessment framework. Taxpayers confronting a denial under an alternative thin capitalisation test may wish to assess whether a higher maximum allowable debt level can be sustained under the ALDT.

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