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Take the lead

Final guidance issued on thin capitalisation

Arm's length debt test (ALDT)

The Australian Taxation Office (ATO) finalised on 12 August 2020 its guidance (Practical Compliance Guideline (PCG) 2020/7) on the application of the arm's length debt test (ALDT), a methodology available to support excess debt deductions above the thin capitalisation safe harbour level.

In conjunction with Taxation Ruling (TR) 2020/4[1] released on the same day, the ATO delivered an increasingly rigorous expectation on how taxpayers should apply the ALDT. The PCG is effective for income years commencing on or after 1 January 2019.

Background

The ATO accepts that the ALDT will be satisfied where, considering (only) the borrower's Australian business, the:

- Entity's debt is not greater than the amount of debt the Australian business would reasonably be expected to have; and
- Debt capital would reasonably be expected to have been provided to the Australian business by independent commercial institutions on arm's length terms and conditions.

Whilst applying the ALDT requires the application of arm's length concepts that are similar to a transfer pricing analysis, it differs from transfer pricing in so far as the analysis is undertaken against a hypothetical entity (based on specific factors contained in the legislation).

The ATO is of the view that there are only limited circumstances in which an independent Australian business would gear in excess of 60% and 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 (such as regulated infrastructure entities). The ATO is therefore of the opinion that the use of the ALDT poses a greater risk of non-compliance compared to using other thin capitalisation methods (such as the safe harbour). PCG 2020/7 represents the ATO's view on what it considers a reasonable approach in undertaking the ALDT and where the ATO will allocate compliance resources. As for other tax risk areas, the ATO uses a colour-zone based categorisation to determine risk, and indicate where it will focus compliance resources.

The risk assessment framework

The PCG sets out the ALDT risk framework into five risk zones:

Risk zone	Facts and circumstances	ATO treatment
White	Arrangements already reviewed and concluded.	No review other than to confirm ongoing consistency with the agreed/determined approach.
Low	Arrangements consistent with low risk criteria specifically developed for inward investing entities, outward investing entities and regulated utilities entities. Some criteria include: 1) inward – debt funding solely from a commercial lending institution, no security or guarantee from an associate 2) outward – widely held publicly-listed 3) regulated – certain financial metrics	No review other than to confirm eligibility to low risk criteria.

[1] TR 2003/1 was replaced.

Risk zone	Facts and circumstances	ATO treatment
Low to moderate	Arrangements consistent with low to moderate risk criteria, including: • credit rating alignment with rating on relevant third party debt • no other features pertaining to the high risk zone are present	The arrangements will be monitored actively with possible review by exception.
Medium	• Arrangements that are not eligible for 'white', 'low' or 'low to moderate' risk zones • features pertaining to high risk zone are not present and • application of the ALDT consistent with the PCG.	The ATO may apply compliance resources to review the ALDT in circumstances such as where: (a) there are concerns that the use of ALDT is not justified (b) the taxpayer's debt capital is subject to a broader review by the ATO. Alternative dispute resolution (ADR) might be effective, however in some instances cases will proceed to audit.
High	Application of the ALDT is not consistent with the PCG, 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 and negative profit before tax during the previous five-year period.	Reviews are likely to be commenced as a matter of priority. Cases might proceed directly to audit, possibly involving the use of formal powers for information gathering. Not eligible to access the advance pricing arrangement program. Practically, it will be more difficult to resolve disputes through settlement or ADR.

ALDT analysis framework

Based on our experience, the majority of taxpayers seeking to use and rely on the ALDT will fall under the medium or high risk zones, meaning the ALDT needs to be applied in accordance with the detailed framework set out in the PCG.

1. Identifying the notional Australian business

The notional Australian business needs to be constructed on a stand-alone entity basis reflecting commercial activities only in connection with Australia and assuming no foreign interests, associate entity debt or credit support provided by associates.

2. Identifying the arm's length terms and conditions

A credit rating for the notional Australian business will need to be established as a reference point for identifying the broader arm's length terms and conditions of debt interest. The ATO notes that this process must be based on independent parties in the same industry and transfer pricing principles.

3. Considering all relevant factors

The ALDT must take into account all the following factors in determining the arm's length debt amount in relation to the Australian business from the perspective of the borrower and independent lenders.

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Quantitative factors	Qualitative factors
• Entity's capacity to meet all its liabilities • Profitability • Return on capital • Debt to equity ratio	• Functions performed, assets used and risks assumed • Terms and conditions of the debt capital the entity actually had • Nature of, and title to, any assets available as security • Purposes of debt arrangement • Debt to equity ratios of each associate entity • Commercial practices in the industry • Way in which other parts of the entity's business are financed • General state of the Australian economy throughout the year • All of the above factors existing at the time the entity last entered into debt capital that remains on issue throughout the year

The quantitative factors need to be weighted to give rise to an arm's length debt amount. The qualitative factors need to be designated as to whether each has an adverse, neutral or supportive impact on the debt amount derived. The ATO notes that the weighting exercise should be based on evidence and publicly available information.

Key takeaway

The final guidance is expected to increase taxpayers' compliance burden in their ALDT self-assessment. Unhelpfully, the ATO has only provided the one example in the PCG, and this example is based on a regulated entity scenario. This leaves significant uncertainty for general industry taxpayers. To meet the ATO's expectation, taxpayers should use best endeavours to put in place a robust analysis and evidence to substantiate an arm's length debt amount.

The ALDT is annual process. However, it is noteworthy that taxpayers may have experienced impairment of asset values or additional debt drawdowns resulting from COVID-19. The ATO allows taxpayers who would otherwise rely on the safe harbour debt amount to apply a simplified approach to the ALDT for the 2020 year provided certain criteria can be met.

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