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AUSTRALIAN TRANSFER PRICING ALERT



Change is coming to the arm's length debt test

On 5 April 2019, the ATO released draft Taxation Ruling 2019/D2 – Income tax: thin capitalisation – the arm's length debt test ("draft ruling"). The draft ruling sets out the ATO's view as to how the legislative provisions of the arm's length debt test ("ALDT") contained in the thin capitalisation rules¹, should be interpreted. The draft ruling is intended to be applied retrospectively, as well as on a go forward basis.

The ATO also plans to release administrative guidance on applying the ALDT via a Practical Compliance Guideline ("PCG"), which will provide insight into more practical aspects. The PCG will replace Taxation Ruling 2003/1, which contains a 6-step methodology that many taxpayers currently rely upon to determine their arm's length debt amount.

Our key observation from the draft ruling relates to the ATO's interpretation of the phrase 'would reasonably be expected'. The arm's length debt amount calls for an objective assessment of what a reasonable hypothetical borrower and commercial lending institution 'would' be expected to borrow and lend. This is emphasised from the perspective of the borrower in that the borrower 'would' borrow as distinguished from an amount the borrower 'could' borrow, and these amounts may not be the same. Furthermore, the draft ruling clarifies that the subjective preferences or intent of the shareholder are not relevant to addressing the phrase.

The ATO's emphasis on this point suggests they will apply a higher standard to the analysis contained in an ALDT and the evidence available in determining what a reasonable expectation 'would' be, with the retrospective application of the draft ruling setting in motion potential conflict with taxpayers who currently or have historically relied upon the ALDT.

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¹Division 820 of the Income Tax Assessment Act 1997.

OTHER OBSERVATIONS

TR 2019/D2 also provides further information regarding the ATO's views with respect to:

- ▶ Interaction between thin capitalisation and transfer pricing – The draft ruling observes that the approach to related party debt from a transfer pricing perspective will differ from the approach taken under the ALDT, for example with respect to the notion of implicit parental support. The ALDT seeks to remove these factors from the analysis whereas a transfer pricing analysis may involve acknowledging the existence of explicit and implicit support.
- ▶ Documentation requirements – The draft ruling notes that the ALDT is an annual test. Whilst the failure to prepare appropriate documentation by the due date does not preclude the ability to rely on the ALDT, it may result in administrative penalties. It is therefore strongly recommended that annual documentation is prepared by the due date, given the ALDT is a subjective test and an area of focus for the ATO.
- ▶ Value of assets and liabilities – Asset valuations under the ALDT are not limited to accounting values. While accounting values are relevant a taxpayer is not precluded from utilising a different value based on various qualitative and quantitative factors.
- ▶ Weighting of 'relevant factors' – The 'relevant factors' under the ALDT should be weighed and the draft ruling outlines that the rationale for the weighting applied should be detailed.
- ▶ Use of retrospective, current and forecast data – It is acknowledged that in some circumstances it may be necessary or appropriate to consider retrospective, current and/or forecast data. To use the forecasted data, it may be necessary to demonstrate that it is a commercially acceptable practice to do so.

- ▶ Measurement points – the arm's length debt amount is an amount that would be reasonable to have throughout the income year and where material changes arise in the business it may be appropriate to determine an arm's length debt amount for different periods and/or averaged.

Finally, the draft ruling is in a consultation process, which is set to end after the election. The future of the ALDT is however, in doubt given the Labor Party's proposal to eliminate the safe harbour and ALDT in favour of a single test (the worldwide gearing ratio). It should be noted that the ALDT was specifically designed to accommodate the commercial practices that are considered industry norms. The worldwide gearing ratio may have regard to these commercial practices and industry norms, however it will not reflect Australian specific factors.

BDO COMMENT

BDO recommend that taxpayers who utilise the ALDT to support their gearing levels in Australia should be aware of the content contained in the draft ruling, consider how the application of the ALDT is affected by the revised guidance and be prepared for the future developments as a result of the proposed PCG and/or the potential changes to the thin capitalisation regime, pending the election result.

If you would like further information in relation to any of the above, please contact your BDO advisor or local transfer pricing specialist.

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