TR 2019/D2 - Income tax: thin capitalisation - the arm's length debt test

This document has been finalised by TR 2020/4.

Draft Taxation Ruling

Income tax: thin capitalisation – the arm's length debt test

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Relying on this draft Ruling

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if the draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

Summary – what this draft Ruling is about

1. This draft Ruling[1] deals with the application of the arm's length debt test contained in the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997).[2]

2. The thin capitalisation rules set a limit on the amount of debt that can be used to finance an entity's Australian operations. For entities that are not authorised deposit taking institutions (non-ADIs), the arm's length debt amount for the year is one amount that can be used to determine an entity's maximum allowable debt. For tax purposes, an entity's debt deductions are reduced to the extent that its adjusted average debt exceeds its maximum allowable debt.

3. This Ruling applies to an entity who seeks to apply the arm's length debt test contained in section 820-105 (for outward investing entities (non-ADI)) and section 820-215 (for inward investing entities (non-ADI)).

4. The purpose of this Ruling is to provide interpretative guidance on key technical issues that may arise in determining an entity's arm's length debt amount. This Ruling also provides interpretative guidance relating to the record-keeping requirements in section 820-980.

5. A draft Practical Compliance Guideline will also be published to provide administrative guidance to taxpayers in applying the test.

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[1] All further references to 'the Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.
[2] All legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

Background

6. The thin capitalisation regime affects Australian entities which are foreign controlled and foreign entities with Australian permanent establishments or Australian investments (inward investing entities). Australian entities that are not foreign controlled can be affected where they have international operations or are associate entities of such entities (outward investing entities).

7. Under the thin capitalisation regime, interest and other debt deductions will be reduced to the extent that an entity's adjusted average debt exceeds the entity's maximum allowable debt.

8. The maximum allowable debt is the greatest of:

- the safe harbour debt amount
- the worldwide gearing debt amount
- the arm's length debt amount.

9. The explanatory memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (EM)[3] notes that an entity is not required to calculate its maximum allowable debt under each test. It has the option of choosing one of the available tests. Thus, if an entity is able to establish under one of the methods that its maximum allowable debt is greater than its adjusted average debt, it will not have to apply another test.

10. The arm's length debt test in sections 820-105 or 820-215 applies to outward investing (non-ADI) entities and inward investing (non-ADI) entities respectively. The tests are substantially similar in content and structure.

11. In order to apply the arm's length debt test it is necessary to identify and isolate the entity's commercial activities in connection with Australia (Australian business).

12. In broad terms, the arm's length debt test will be satisfied where, considering the borrower's Australian business:

- the entity's adjusted average debt is not greater than the amount of debt the Australian business would reasonably be expected to have
- the 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.

[3] At paragraph 2.30.

Subsections 820-105(1) and 820-215(1)

13. Subsections 820-105(1) and 820-215(1)[4] introduce the concept of arm's length debt amount and specify the relevant test. The arm's length debt amount is a notional amount determined having regard to certain specified factual assumptions and relevant factors.

14. The test calls for a calculation of how much debt the Australian business would reasonably be expected to have under the legislative assumptions and factors. This is based on two separate questions:

- What amount of debt capital attributable to its Australian business, and that gives rise to debt deductions, would the entity reasonably be expected to have throughout the income year?
- Would independent commercial lending institutions reasonably be expected to lend that amount to the entity under terms and conditions that would reasonably be expected if the lenders and the entity were dealing at arm's length?

Subsections 820-105(2) and 820-215(2)

15. Subsection (2) specifies the factual assumptions that must be taken into account in working out the notional amount. The factual assumptions prescribe the setting for working out the arm's length debt amount. The scenario developed is one which would exist if the entity had been dealing with independent commercial lending institutions, without credit support of related parties. Under this scenario, regard must only be had to the circumstances of the entity's Australian business.

16. Paragraphs 820-105(2)(a) and 820-215(2)(a) differ depending upon the classification of the entity for thin capitalisation purposes.

Outward investing entities (non-ADI)

17. The assumption in paragraph 820-105(2)(a) provides that the entity's commercial activities in connection with Australia (the Australian business) does not include any business carried on at or through an overseas permanent establishment and the holding of any associate entity debt, controlled foreign entity debt or controlled foreign entity equity.

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[4] For readability, future references in this Ruling to elements of both section 820-105 and 820-215 have been abbreviated, and should be read as applying to the arm's length debt test in each section unless otherwise indicated.

Inward investing entities (non-ADI)

18. The assumption in paragraph 820-215(2)(a) provides that the entity's commercial activities in connection with Australia (the Australian business) does not include the holding of any associate entity debt if the entity is an inward investment vehicle (general) or (financial).

19. For an entity that is an inward investor (general) or (financial) the Australian business during the year consists only of its Australian investments (as defined) other than the holding of any associate entity debt that is attributable to its Australian permanent establishments.

20. The remaining paragraphs of subsections 820-105(2) and 820-215(2) are consistent and include the following assumptions:

- The entity had carried on the Australian business that it actually carried on during that year (paragraph (2)(b)).
- The nature of the entity's assets and liabilities (to the extent they are attributable to the Australian business) had been as they were during that year (paragraph (2)(c)).
- The entity had carried on the Australian business in the same circumstances as what actually existed during that year (except as required by paragraphs (1)(b) and (2)(e), (f) and (g)) (paragraph (2)(d)).
- The entity's only activities during that year were the Australian business (paragraph (2)(f)).
- The entity's only assets and liabilities during that year were those referred to in paragraph (2)(c) (paragraph (2)(g)).

21. A further variation to the actual characteristics of the entity is made to exclude the impact of any guarantee, security or credit support provided by associates or by the use of assets attributable to the entity's overseas permanent establishments. The assumption is that any guarantee, security or other form of credit support provided to the entity in relation to its Australian business during that year is taken not to have been received by the entity (paragraph (2)(e)).

Subsections 820-105(3) and 820-215(3)

22. Subsection (3) specifies the relevant factors that must be taken into account in determining the notional amount under the test in subsection (1). The relevant factors are intended to reflect considerations that might be expected to be taken into account by an entity in contemplating the appropriate mix of equity and debt capital for its business. They also reflect what independent commercial lending institutions would consider when contemplating whether to provide debt funding for that business, and if so, how much to lend.

The relevant factors must be considered in the context of the prescribed factual assumptions in subsection (2).

23. Determining the arm's length debt amount is an exercise that needs to be carried out from the perspective of both the borrower and the independent commercial lenders. Whilst all the legislative factors must be taken into account, some factors will be more important to the borrower and others to the lender. The weight given to a particular factor will depend upon the precise facts and circumstances of the entity in the tested year.

Subsections 820-105(4) and 820-215(4)

24. An entity self-assesses the arm's length debt amount in relation to its Australian business. If the Commissioner considers that the specified assumptions and relevant factors have not been appropriately taken into account, the Commissioner may substitute a new amount that the Commissioner considers better reflects those assumptions and factors.

Definitions

25. This section explains some defined terms that deserve particular comment in the context of this Ruling.

- **Adjusted average debt** for an income year is defined for outward investing entities in subsection 820-85(3) and for inward investing entities in subsection 820-185(3). An entity's adjusted average debt for an income year represents the average value of the entity's debt capital that gives rise to debt deductions with certain adjustments. Where the adjusted average debt exceeds maximum allowable debt, a proportion of debt deductions will be disallowed.
- **Arm's length** appears in section 995-1 and provides that in determining whether parties deal at arm's length consider any connection between them and any other relevant circumstance. The term appears in paragraph (1)(b) of the arm's length debt test. In determining what amount commercial lending institutions would reasonably be expected to lend, the debt interests must provide for terms and conditions that would reasonably be expected to have applied if the entity and the notional lenders had been dealing at arm's length with each other. This arm's length requirement is considered to be the same as other arm's length tests in that it postulates what separate enterprises dealing at arm's length with each other would do. Importantly, however, this test must be

applied in the context of the notional Australian business that is constructed in subsection (2) of the arm's length debt test. So whilst the concept of arm's length is generally consistent with the concept recognised for transfer pricing purposes, the legislative requirements of the arm's length debt test are different to those presented in Subdivision 815-B. This distinction is discussed further in paragraphs 93 to 104 of this Ruling.

- **Debt deduction** is defined in section 820-40. Debt deduction is defined very widely and embraces costs incurred by an entity in relation to debt interests. One of the requirements of the notional arm's length debt amount is that it would give rise to an amount of debt deductions of the entity for that year or any other income year.

Previous rulings

26. This Ruling, along with the planned draft practical compliance guideline, will replace existing Taxation Ruling TR 2003/1 *Income tax: thin capitalisation – applying the arm's length debt test*. It is intended that TR 2003/1 will be withdrawn when this Ruling is published in final with effect from the date of publication of the final Ruling.

27. The purpose of TR 2003/1 was to provide practical guidance in determining an entity's arm's length debt amount. TR 2003/1 was not a 'public ruling' for the purposes of former Part IVAAA of the *Taxation Administration Act 1953* (TAA 1953) and did not rule on the application of a tax law, as defined at the time it issued. TR 2003/1 provides a suggested six step methodology that could be used to arrive at the arm's length debt amount. The six step methodology will not be replicated in the new guidance. Instead the Commissioner intends to provide new guidance relating to the practical operation of the arm's length debt test in the planned Guideline.

Ruling

The arm's length debt amount

28. The arm's length debt amount of an entity is a notional amount that, having regard to the factual assumptions set out in subsection (2) and the relevant factors set out in subsection (3), would satisfy both paragraphs (1)(a) and (1)(b). That is, an application of the test effectively requires the quantification of an amount pursuant to the borrower's test in paragraph (1)(a) and the commercial lender's test in paragraph (1)(b).

29. Given the different requirements of each paragraph an amount quantified under each limb of the test may, and likely will, be different. However the legislation requires the arm's length debt amount must satisfy both paragraphs. It follows only the lower amount can satisfy each limb and consequently the arm's length debt amount is that lower amount.

'Would reasonably be expected'

30. The arm's length debt test contains the phrase 'would reasonably be expected' in the context of setting out the test in paragraphs (1)(a) and (b). Broadly, the arm's length debt amount is a notional amount of debt capital that:

- the entity (borrower) **would reasonably be expected** to have (the borrower's test)
- commercial lending institutions **would reasonably be expected** to have lent (the commercial lender's test).

31. The meaning of this phrase is critical to an application of the arm's length debt test. The test requires an objective assessment of what a reasonable hypothetical borrower and commercial lending institution would be expected to borrow and lend in the facts and circumstances of the entity (as are assumed to exist pursuant to subsection (2)).

32. The phrase has been judicially considered on many occasions and the settled meaning is considered applicable in the current legislative context. In considering Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936), the High Court in *Commissioner of Taxation (Cth) v Peabody* [1994] HCA 43:

> A reasonable expectation requires more than a possibility. It involves a prediction as to events which would have taken place if the relevant scheme had not been entered into or carried out and the prediction must be sufficiently reliable for it to be regarded as reasonable.

33. In the Full Federal Court decision for that case[5] Hill J noted an "'expectation' requires that the hypothesis be one which proceeds beyond the level of mere possibility to become that which is the expected outcome".

34. The standard of test is higher than a prediction of a possible level of debt and calls for a prediction based upon evidence. The amount of debt giving rise to debt deductions must be a reasonably likely or expected position having regard to the legislative requirements. The test in subsection (1) is not seeking to identify the highest debt amount possible as more than a mere possibility is required, rather the amount must be probable.

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[5] *Peabody, M.G v. Commissioner of Taxation* [1993] FCA 98.

The borrower's test

35. In the borrower's test in paragraph (1)(a) an amount that a borrower 'would' borrow is to be distinguished from an amount the borrower 'could' borrow.

36. The debt amount a borrower 'would' reasonably be expected to have will be dependent upon an objective assessment of the facts and circumstances of the entity. By only addressing the test from the perspective of what the borrower 'could' borrow is to address the second limb of the arm's length debt test in isolation. In other words, what the borrower could borrow is analogous to the question to be addressed in paragraph (1)(b); the borrower **could** borrow what the commercial lender **would** lend.

37. Whilst a borrower may have capacity to take on additional debt it does not mean that it would do so. A borrower's willingness to take on debt will depend upon a range of considerations that vary to those relevant to a lender. A borrowing decision of the entity will be influenced by the overall cost of funding and the need to ensure an appropriate return to equity investors.

The arm's length debt amount must be determined each income year

38. The arm's length debt test requires the determination of a notional amount the entity would reasonably be expected to have throughout the income year. The test must be applied in relation to the year of income under consideration and there is a requirement to determine the arm's length debt amount each income year in which the entity is seeking to rely on the test.

39. There is an express requirement pursuant to paragraph (3)(k) to consider all the factors listed in subsection (3) at the time when the entity last entered into a scheme that gave rise to an actual debt interest that remains on issue (note this does not refer to all debt interests on issue in the testing year as the 'last' scheme is only specified as relevant). Depending upon the relevant facts and circumstances, an analysis of factors in the year the entity last raised debt may be important. For example, where further debt has not been raised and the facts and circumstances in the year the debt was raised and the current year are similar.

40. However, this does not suggest current year testing is not required but rather that a prior year application of the arm's length debt test may remain reasonably expected in the specific circumstances that exist in the current year.

41. It is possible that an entity with the same financing arrangements may satisfy the arm's length debt test in one year but fail it in a subsequent year if the relevant facts and circumstances have changed to a degree the debt is no longer taken to satisfy the test.

Definition of Australian business

42. Subsection (2) specifies that irrespective of what actually happened during the year, various assumptions must be made in determining the arm's length debt amount. The construct developed is one that focuses on the Australian business of the entity, to the exclusion of foreign investments.

43. The 'Australian business' includes the entity's commercial activities in connection with Australia and then goes on to carve out various amounts. What comprises the entity's Australian business depends upon whether it is an inward or an outward investing entity.

Inward investing entities

44. For an inward investing entity that is a foreign entity, the Australian business will comprise of its permanent establishments in Australia as well as any other assets that are held for the purposes of producing the entity's Australian assessable income. Where the inward investing entity is a foreign controlled Australian entity, the Australian business comprises the entity's commercial activities connected with Australia. Any holdings of associate entity debt are excluded and as such any interest income attributable to associate entity debt must be disregarded for the purposes of the test.

Outward investing entities

45. For an outward investing entity the Australian business comprises all of the entity's commercial activities in connection with Australia other than any business carried on, at or through its overseas permanent establishments. The Australian business also does not include the holding of associate entity debt, controlled foreign entity debt or controlled foreign entity equity. It follows that any interest income attributable to associate entity debt and controlled foreign entity debt must be eliminated from an outward investing entity's notional Australian business for the purposes of the test. Similarly, any dividend income attributable to controlled foreign entity equity should be disregarded.

46. For an outward investing entity the Australian business will include activities that give rise to foreign source income where these activities do not give rise to a foreign permanent establishment.

47. The holding of controlled foreign entity debt and controlled foreign entity equity is excluded from the Australian business, however any transactions not connected to the holding of the debt or equity that occur between the tested entity and the controlled foreign entity are part of the Australian business, so long as they are attributable to commercial activities in connection with Australia. For example, the Australian business of the entity will include active income streams derived from transactions with its controlled foreign

entity such as sales and management fees and other passive income streams such as royalties.

48. Whilst dividends received by the entity on holdings of controlled foreign entity equity are not taken into account as part of the Australian business, the accumulated cash from such dividends may become an asset of the Australian business. Once the cash is held by the entity it is no longer connected to the holding of controlled foreign entity equity and becomes a resource of the entity available to use in the Australian business (for example, to repay debt, undertake capital expenditure or otherwise employ in the working capital of the Australian business). Similarly, the accumulation of cash from the receipt of interest income on excluded debt amounts may also become an asset of the Australian business.

49. In defining the Australian business, the holding of associate entity equity is not expressly excluded and is therefore also relevant to the activities of the Australian business.

Can the shareholders of the entity be taken into account in applying the arm's length debt test?

50. In addition to constructing the Australian business to the exclusion of certain foreign investments, subsection (2) also requires the following assumptions be made:

- the entity had carried on the Australian business that it actually carried on during that year (paragraph (2)(b))
- except as stated in paragraphs (1)(b) and (2)(e), (f) and (g), the entity had carried on the Australian business in the same circumstances as what actually existed during that year (paragraph (2)(d)).

51. An issue that arises in this context is which actual facts and circumstances must be taken into account in applying the test – in particular, can the entity's shareholders be taken into account?

52. In addressing the assumptions required by the arm's length debt test, the EM notes[6]:

> Those assumptions and factors establish a scenario that would have existed if the entity's Australian operations were independent from any other operations that the entity or its associates had during the period, and had been financed by an acceptable mix of equity and debt funding.

53. The EM goes on[7] to discuss the identification of the Australian business and how the principal purpose of the assumption is to isolate the entity's Australian operations from its foreign operations. It is acknowledged that whilst the design of the assumptions differs

[6] At paragraph 10.11.
[7] At paragraph 10.20.

between an inward and outward investing entity, the object of focusing only on the Australian operations is the same for both.

54. The assumption in paragraph (2)(b) (that the Australian operations had been carried on as they actually were) and the assumption in paragraph (2)(d) (that the Australian business was carried on in the same circumstances as what actually existed during the year) are viewed as meaning the relevant assumptions take into account the way the Australian business did in fact perform and the context in which that performance took place. In this regard, the context may include the regulatory, political and financial environment in which the business was carried on. The circumstances are referenced to the carrying on of the business and remain tied to the actual operations conducted. This will include consideration of the management of the Australian business.

55. It may be the case that management policy reflects the capital structure and leverage preferences of the shareholders. However given the legislative task is to answer the question of what is an amount of debt that would reasonably be expected those subjective preferences are not relevant. The legislative task is to determine what amount of debt would reasonably be expected and this question is not addressed by asserting the entity did in fact wish or intend to have high leverage.

56. However, management may implement operational changes to the Australian business that may ultimately lead to substantiation of a higher arm's length debt amount. For example, the management of a business may implement a cost reduction program and close down poorly performing parts of the business – such actions and plans may impact the financial performance of the Australian business and may be taken into account in the assumptions and factors to influence the arm's length debt amount.

57. The EM indicates the entity is to be viewed independently from foreign operations and the legislative assumptions contained in subsection (2) direct attention to the operations of the Australian business. Neither the EM nor the legislative provisions refer to the shareholders of the entity; rather the focus is on the entity's activities alone. Accordingly, the entity's position as a member of a global group should be disregarded for the purpose of applying the arm's length debt test.

Values that may be taken into account in applying the arm's length debt test

58. In determining a notional amount under subsection (1) of the arm's length debt test, it is also necessary to have regard to the assumption in paragraph (2)(c). The paragraph requires an assumption be made that the nature of the entity's assets and liabilities (to the extent they are attributable to the Australian business) had been as they were during the year.

59. Section 820-680 is stated to apply for the purposes of Division 820 and mandates that an entity must comply with the accounting standards in determining what are its assets and liabilities and in calculating the value of its assets, liabilities (including debt capital) and equity capital.

60. The Commissioner is of the view that section 820-680 does not operate in the context of the arm's length debt test to limit the basis upon which assets may be taken into account for the purpose of applying the test.

61. It is necessary to identify the entity's commercial activities in connection with Australia and such activities are identified as including the assets that the entity uses or has available for deriving income (to the exclusion of certain foreign investments).

62. Assets determined and calculated in accordance with the accounting standards are expected to be relevant to an application of the arm's length debt test, however an entity is not necessarily precluded from taking into account another relevant value of its assets in applying the test.

63. The application of the arm's length debt test is different to the safe harbour test that specifically requires the determination and calculation of an asset for the purpose of inclusion in a calculation prescribed in Division 820. The arm's length debt test does not include such a calculation and instead requires various factors to be taken into account in determining an amount of debt that would reasonably be expected. Some of the factors are qualitative in nature and others are quantitative. The test necessarily requires an exercise of judgment as a precise calculation methodology is not prescribed. The test does refer to assumptions that must be made and these are typically directed toward the commercial activities actually carried on to the extent they relate to the Australian business.

64. The factor in paragraph (3)(c) specifies that in determining whether an amount satisfies paragraphs (1)(a) and (b) the nature of, and title to, any assets of the entity attributable to the Australian business that were available to the entity throughout the year as security for its debt capital must be taken into account. This factor is directed toward consideration of matters that commercial lenders would typically have regard to. The factual assumption in paragraph (2)(c) specifically directs the entity to assume, for the purpose of applying the test, that the nature of the entity's assets and liabilities had been as they were during the year. The word 'nature' in this context is not defined and takes its ordinary meaning, relevantly the basic or inherent features or character of the asset must be considered. Such an enquiry is necessarily broader than a consideration of assets determined and valued in compliance with accounting standards. For example, the legal ownership of a physical asset may be relevant for a commercial lending institution to assess asset backing, whereas intangible assets such as goodwill may not be taken into account in assessing security (regardless of whether the asset is recognised under accounting standards or not).

65. The statutory context of the arm's length debt test does not lend itself to being constrained to assets determined and calculated under the accounting standards. The list of factors that must be taken into account under subsection (3) are broad and the relevance and application of the factors will depend on the facts and circumstances of the entity.

66. Paragraph (3)(h) requires the commercial practices adopted by independent parties dealing with each other at arm's length in the industry in which the entity carries on the Australian business to be taken into account. It is conceivable that if an industry were subject to particular lending practices that incorporated financial metrics based on other valuation approaches this factor would enable those values to be considered relevant.

67. Paragraph (3)(g) requires the debt to equity ratios of the entity, the entity in relation to the Australian business and each of the entity's associates that engage in commercial activities similar to the Australian business to be taken into account. The term 'debt to equity ratios' is not defined in the legislation and should be given its ordinary meaning. In practice this ratio can be calculated in a range of ways depending upon context.

Commercial lending institutions

68. The term 'commercial lending institutions' appears in paragraph (1)(b) and is relevant in determining the notional amount commercial lending institutions would reasonably be expected to have provided on arm's length terms and conditions. The term is not defined in the ITAA 1997.

69. The term encompasses commercial lending institutions that are banks and ADIs, and it is considered the phrase is also broad enough to extend to the raising of debt capital on any market whose commercial activities extend to the provision of debt capital on arm's length terms and conditions. The raising of debt on the bond market is such an example.

Implicit and explicit credit support

70. An assumption must be made in working out the arm's length debt amount that any guarantee, security or other form of credit support provided to the entity in relation to the Australian business during that year by its associates or by the use of assets of the entity that are attributable to the entity's overseas permanent establishments is taken not to be received (paragraph (2)(e)).

71. This assumption ensures any form of credit support provided by associates is disregarded in constructing the notional business for the purpose of working out the arm's length debt amount.

72. Any explicit form of support (for example, a formal guarantee provided by a parent) or implicit credit support (such as a non-binding

letter of comfort or an incidental benefit from the entity's passive affiliation with the multinational group to which it belongs) is to be disregarded. The provision does not seek to distinguish between contractual and non-contractual forms of support and should be given a broad meaning. This is consistent with the underlying policy of the assumptions contained in subsection (2) which assume the independent existence of the entity.

73. An analysis of the entity's facts and circumstances is required to determine the impact of explicit and implicit support and it is acknowledged the impact of such support will vary depending upon those facts and circumstances.

Weighting of factors

74. The arm's length debt amount determined under subsection (1) must be worked out adopting the assumptions in subsection (2) and taking into account the relevant factors in subsection (3). There is no discretion permitted in subsection (3) and the factors listed must be taken into account.

75. The weight given to each factor in the analysis will vary depending upon the facts and circumstances of the case. Some factors will be more important for a borrower and some for the lender. Whilst all of the relevant factors must be taken into account in determining the notional amount, this does not mean that every single factor will have a material impact on the quantum of the arm's length debt amount.

76. Subsection 820-980(2) states the entity's records must contain particulars about the factual assumptions and relevant factors that have been taken into account in working out the arm's length debt amount. The particulars should include detail of the weighting given to each factor along with the rationale for why that conclusion has been reached.

77. The concept of weighting factors is readily understood in a commercial context as bank-lending criteria weigh various factors in deciding whether and how much to lend. Credit rating agencies also adopt a similar approach and publish industry reports indicating how certain factors should be weighted in considering the credit risk of an entity within a particular industry. Such information may be relevant in determining the weight to be given to the relevant factors from the perspective of applying the commercial lenders test in subsection (1)(b).

Measurement points

78. The arm's length debt test requires the determination of a notional amount of debt capital the borrower would reasonably be expected to have **throughout the income year** and that a commercial lending institution would reasonably be expected to have

lent if the parties were dealing at arm's length **throughout the income year**.

79. Subdivision 820-G sets out the methods for calculating an average value for the purposes of Division 820. However there is no specific requirement to calculate the average value of a matter in the arm's length debt test.

80. In applying the arm's length debt test, there is no single approach or method that will result in an amount that would reasonably be expected to exist throughout the year in all instances – this necessarily depends on the facts and circumstances of the entity and each year in question.

81. It may be appropriate in some circumstances to adopt measurement days (such as those provided for in Subdivision 820-G). Where there are changes in the Australian business during the year, the arm's length debt test may need to be determined for different periods and averaged.

Retrospective, current and forecast data

82. In applying the arm's length debt test the factors in subsection (3) must be taken into account and whilst many of those factors are predicated on the use of current year data there will be circumstances in which it is necessary or appropriate to also take into account retrospective and/or forecast data.

83. Certain paragraphs of subsection (3) require the use of data from other periods. The factor listed at paragraph (3)(e) requires the entity's capacity to meet all its liabilities in relation to the Australian business whether during the tested year or at any other time to be taken into account. Paragraph (3)(f) requires the profit of the entity (within the meaning of the accounting standards) and the return on its capital in relation to the Australian business, whether during the tested year or at any other time to be taken into account.

84. It is expected an entity's historical and forecast cash flow and profit will be relevant in addressing these factors.

85. The factor in paragraph (3)(k) requires all of the factors listed in subsection (3) that existed at the time the entity last entered into a scheme that gave rise to an actual debt interest attributable to the Australian business that remains on issue in the test year to also be taken into account.

86. In addition to these requirements for testing during specific periods of time, paragraph (3)(h) necessitates the commercial practices adopted by independent parties dealing with each other at arm's length in the industry in which the entity carries on the Australian business throughout the year (whether in Australia or in comparable markets elsewhere) be taken into account. On the basis it can be demonstrated that the relevant commercial practices permit the consideration of forecast financial data then such information should be available to be taken into account in applying

subsection (3). For example, an entity may be able to demonstrate that relevant commercial practices take into consideration the forecast financial performance when structuring debt arrangements used to fund an asset or business acquisition.

Documentation requirements

87. Section 820-980 provides that an entity must keep records for an arm's length debt amount. The records must contain particulars about the factual assumptions and relevant factors that have been taken into account in working out that amount. Proper records must be prepared by an entity seeking to apply the arm's length debt test to demonstrate the test has been applied appropriately in the circumstances.

88. The entity must prepare the records before the time by which the entity must lodge its return for the relevant income year. There is a note to section 820-980 referencing that a person must comply with section 262A of the ITAA 1936.

89. Subsection 262A(1) of the ITAA 1936 requires that a person carrying on a business must keep records that record and explain all transactions and other acts engaged in by the person that are relevant for any purpose of this Act. Section 288-25 of Schedule 1 to the TAA 1953 imposes an administrative penalty if the entity does not keep or retain records as required by the section.

90. A failure to keep the records required by section 820-980 by the due date by which the entity must lodge its income tax return may result in the imposition of a penalty.

91. However, a failure to prepare the records required by section 820-980 by the due date does not result in an inability to rely on the arm's length debt test as the maximum allowable debt for the relevant income year, provided all other requirements are satisfied. The identification of maximum allowable debt is not a choice or election that is binding and irrevocable once made. The statutory framework provides that the maximum allowable debt for an entity is the greater of the amounts worked out under the applicable tests. For example, subsection 820-90(1) specifies the maximum allowable debt for an income year is the greatest of the following:

- the safe harbour debt amount
- the arm's length debt amount
- the worldwide gearing debt amount.

92. Other provisions may then impose further obligations on the entity in relation to the application of a particular test however, section 820-980 is not considered to be more than a record-keeping obligation.

Interaction with the transfer pricing rules

93. In certain circumstances an entity applying the arm's length debt test will need to consider the requirements of the cross border transfer pricing rules in addition to those contained in the arm's length debt test. Whilst both regimes require consideration of arm's length principles there are important differences in the respective statutory frameworks.

94. An important distinction in this regard relates to the identification of the notional Australian business. The arm's length debt test is a statutory test that requires the determination of a notional amount of debt to be arrived at after taking into account the assumptions listed in subsection (2). It is not a test applied to all the facts and circumstances of the entity, and is instead a test applied to the facts and circumstances legislatively prescribed to exist.

95. An entity applying the arm's length debt test must assume no guarantee, security or other form of credit support is provided to the entity from its associates and that the only business is the Australian business of the entity (per subsection (2)). No equivalent assumptions exist in determining the arm's length conditions for the purpose of Subdivision 815-B.

96. Accordingly, the construct of the notional business for the purpose of determining the arm's length debt amount may differ to the circumstances that exist when evaluating the arm's length conditions for transfer pricing purposes.

97. A financing arrangement that is not adjusted for transfer pricing purposes, as no transfer pricing benefit arises, is not necessarily accepted as providing for terms and conditions that would reasonably be expected to have applied if the entity and notional lender had been dealings at arm's length with each other for the purposes of the arm's length debt test.

98. The notional debt under paragraph (1)(b) is determined having regard to the relevant assumptions in subsection (2) and provides that the notional amount of debt capital must provide for terms and conditions that would reasonably be expected to have applied if the entity and the notional lenders had been dealing at arm's length with each other throughout the income year.

99. Those terms and conditions may differ to those accepted for transfer pricing purposes due to the construct of the notional Australian business and fact the arm's length terms and conditions may be less advantageous to the entity (that is, there is no need for a transfer pricing benefit to arise).

100. By way of example, assume the entity has issued related party debt that is interest-free, but otherwise gives rise to a debt deduction, and the circumstances are such that no transfer pricing benefit arises. Also assume the debt is not on arm's length terms and conditions for the purpose of subsection (1)(b) due to the fact the interest rate is lower than would apply if it were issued on arm's length terms. For the purpose of testing, if the actual debt amount

satisfies the arm's length debt test it would then be necessary for the entity to consider the relevant factors in subsection (3) taking into account an arm's length (that is, higher) interest cost applicable to the debt. This in turn will lead to lower interest coverage and serviceability ratios than would otherwise be the case and may have the result that the actual debt amount exceeds the arm's length debt amount.

101. Accordingly, it is not reasonable to assume that no adjustment is required to debt terms and conditions for the purpose of applying the arm's length debt test simply on the basis the arrangement has not given rise to a transfer pricing benefit. Equally it is not reasonable to assume that debt that is accepted as being on arm's length terms and conditions for arm's length debt test purposes will not give rise to a transfer pricing benefit.

The role of section 815-140

102. Section 815-140 modifies the way the arm's length conditions would otherwise be substituted when an entity gets a transfer pricing benefit and the thin capitalisation rules apply.

103. The rule applies in a manner that requires the costs that are debt deductions to be determined as if the arm's length conditions operated but the substituted rate is then applied to the actual debt interest issued by the entity. Section 815-140 only operates to modify how the entity works out its taxable income or tax loss under section 815-115. The operation of section 815-140 does not impact an application of the arm's length debt test.

104. The thin capitalisation rules can then be applied to the actual amount of debt issued that is relevant in determining the entity's adjusted average debt. In applying the test, the entity must determine the arm's length debt amount by applying the legislative tests contained in sections 820-105 or 820-215 as applicable to the notional Australian business. If the maximum allowable debt under the arm's length debt test is less than the entity's adjusted average debt the calculation of any debt deduction denial will reflect the debt deductions substituted under Subdivision 815-B.

Date of effect

105. When the final ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
5 April 2019

Appendix 1 – Your comments

106. You are invited to comment on this draft Ruling, including the date of effect. Please forward your comments to the contact officer by the due date.

107. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments
- be published on the ATO website at ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date:	**2 August 2019**
Contact officer:	**Cindy Perryman**
Email address:	**PGIFinancing@ato.gov.au**
Telephone:	**(03) 8632 5684**

Appendix 2 – Detailed contents list

108. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10; TR 2014/6

Previous Rulings/Determinations:

TR 2003/1

Legislative references:

- ITAA 1997
- ITAA 1997 Subdiv 815-B
- ITAA 1997 815-115
- ITAA 1997 815-140
- ITAA 1997 Div 820
- ITAA 1997 Subdiv 820-G
- ITAA 1997 Subdiv 820-L
- ITAA 1997 820-40
- ITAA 1997 820-85
- ITAA 1997 820-85(3)
- ITAA 1997 820-90
- ITAA 1997 820-90(1)
- ITAA 1997 820-105
- ITAA 1997 820-105(1)
- ITAA 1997 820-105(1)(a)
- ITAA 1997 820-105(1)(b)
- ITAA 1997 820-105(2)
- ITAA 1997 820-105(2)(a)
- ITAA 1997 820-105(2)(b)
- ITAA 1997 820-105(2)(c)
- ITAA 1997 820-105(2)(d)
- ITAA 1997 820-105(2)(e)
- ITAA 1997 820-105(2)(f)
- ITAA 1997 820-105(2)(g)
- ITAA 1997 820-105(3)
- ITAA 1997 820-105(3)(c)
- ITAA 1997 820-105(3)(e)
- ITAA 1997 820-105(3)(f)
- ITAA 1997 820-105(3)(g)
- ITAA 1997 820-105(3)(h)
- ITAA 1997 820-105(3)(k)
- ITAA 1997 820-105(4)
- ITAA 1997 820-185(3)
- ITAA 1997 820-215
- ITAA 1997 820-215(1)
- ITAA 1997 820-215(1)(a)
- ITAA 1997 820-215(1)(b)
- ITAA 1997 820-215(2)
- ITAA 1997 820-215(2)(a)
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- ITAA 1997 820-215(3)(f)
- ITAA 1997 820-215(3)(g)
- ITAA 1997 820-215(3)(h)
- ITAA 1997 820-215(3)(k)
- ITAA 1997 820-215(4)
- ITAA 1997 820-680
- ITAA 1997 820-980
- ITAA 1997 820-980(2)
- ITAA 1997 995-1
- ITAA 1936
- ITAA 1936 Part IVA
- ITAA 1936 262A
- ITAA 1936 262A(1)
- TAA 1953
- TAA 1953 Part IVAAA
- TAA 1953 Sch 1 288-25

Cases relied on:

- Commissioner of Taxation (Cth) v Peabody [1994] HCA 43; (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344; (1994) 68 ALJR 680; (1994) 123 ALR 451
- Peabody, M.G. v Commissioner of Taxation [1993] FCA 98; (1993) 40 FCR 531; 93 ATC 4014; (1993) 25 ATR 32; (1993) 112 ALR 247

Other references:

- Explanatory Memorandum to New Business Tax System (Thin Capitalisation) Bill 2001

ATO references
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