

# ***TR 2002/D4 - Income tax: thin capitalisation - applying the arm's length debt test***



This cover sheet is provided for information only. It does not form part of *TR 2002/D4 - Income tax: thin capitalisation - applying the arm's length debt test*

This document has been finalised by TR 2003/1.



## Draft Taxation Ruling

### Income tax: thin capitalisation – applying the arm’s length debt test

Contents	Para
What this Ruling is about	1
Date of Effect	15
Ruling and Explanation	16
A suggested step-by-step methodology	50
Applying the Test in Practice	76
Example	120
Detailed contents list	127
Your comments	128

#### *Preamble*

*Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.*

## What this Ruling is about

### Thin Capitalisation and the Arm’s Length Debt Amount

1. This Ruling deals with the application of the arm’s length debt test in the new thin capitalisation regime that has been introduced into the *Income Tax Assessment Act 1997* (ITAA 1997) by the *New Business Tax System (Thin Capitalisation) Act 2001*. These changes implement recommendations of the Review of Business Taxation, *A Tax System Redesigned*.

2. In relation to entities that are not authorised deposit taking institutions (non-ADIs), the new regime sets a limit on the amount of debt that can be used to finance their Australian operations. 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<sup>1</sup> are reduced to the extent that its adjusted average debt exceeds its maximum allowable debt.

3. The purpose of the ruling is to provide practical guidance that can be of assistance in determining an entity’s arm’s length debt amount. The law does not specifically prescribe how the arm’s length debt amount is arrived at. This ruling sets out a six step methodology which may assist taxpayers to determine the arm’s length debt amount. The methodology set out in the ruling is one that entities may wish to adopt when working out this amount. Whatever methodology is adopted, the factual assumptions and relevant factors contained in the thin capitalisation regime must still be taken into account.

---

<sup>1</sup> The meaning of “debt deduction” and other terms is explained under key concepts after paragraph 6.

# TR 2002/D4

## Class of persons/arrangements

4. This ruling applies to taxpayers who seek to apply the arm's length debt test contained in the new thin capitalisation regime at sections 820-105 and 820-215 of the ITAA 1997. However, this ruling does not cover the arm's length capital amount for authorised deposit-taking institutions ("ADIs") for the purposes of the *Banking Act 1959*, and referred to in sections 820-315 and 820-410 of the ITAA 1997.

5. The new regime affects Australian entities which are foreign controlled and foreign entities with Australian permanent establishments or which are holding Australian investments (inward investing entities). Australian entities that are not foreign controlled can be affected where they have international operations (for example interests in an overseas entity or a foreign permanent establishment) or are associate entities of such entities (outward investing entities).

6. The scope of the legislation is limited by two de minimis thresholds based on total debt deductions and assets. If the entity together with its associate entities have debt deductions of \$250,000 or less, the thin capitalisation regime will not operate to deny any deductions. The regime will also not operate on outward investing entities, that are not also inward investing entities, if the average Australian assets of the entity and its associates comprise 90% or more of their average total assets.

## Key Concepts and Definitions

**"ADI"** is defined in subsection 995-1(1) and means a body corporate that is an authorised deposit-taking institution for the purposes of the *Banking Act 1959*.

**"Adjusted average debt"** 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 the safe harbour debt amount (and the worldwide gearing debt amount if applicable), the arm's length debt amount may be used and compared with the adjusted average debt to determine the proportion, if any, of the debt deductions that is to be disallowed.

**"Arm's length debt amount"** is a notional amount that may be calculated for the purposes of determining the maximum allowable debt of a taxpayer for an income year. It is defined in sections 820-105 and 820-215.

“**Associate entity debt**” is defined in section 820-910. Note that this term refers to amounts *lent* to associate entities. Associate entity debt is excluded from the Australian business when determining the arm’s length debt amount of the entity.

“**Attributable to**” is used to identify assets and liabilities of the Australian business. This in turn is a key factor in determining how the Australian business would have been funded at arm’s length. The term is also used to identify credit support provided by assets used in the overseas permanent establishments of the entity that is disregarded for the purposes of determining the arm’s length debt amount. The ATO considers that the concept of “attributable” is essentially the same as that used under the principles in double tax agreements for attribution of business profits to permanent establishments and in other parts of domestic law, see Taxation Ruling TR 2001/11 paragraphs 3.15 – 3.19.

“**Australian business**” means the entity’s commercial activities in connection with Australia. “Commercial” indicates that, in the case of an individual, private or domestic activities are excluded. What comprises the entity’s Australian business depends upon whether it is an inward or an outward investing entity. The meaning of the phrase is provided in subsections 820-105(2) and 820-215(2).

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 of the entity’s commercial activities connected with Australia. Any holdings of associate entity debt is excluded by the legislation. If the inward investing entity is also an outward investing entity, the entity is treated as an outward investing entity.

For an outward investing entity the Australian business comprises all of the entity’s commercial activities in connection with Australia other than those conducted at or through its overseas permanent establishments. The Australian business does not include the holding of associate entity debt, controlled foreign entity debt or controlled foreign entity equity.

The holding of associate entity equity is not excluded from the activities of the Australian business (unless it is controlled foreign entity equity).

For an outward investing entity the Australian business also includes commercial activities that give rise to foreign source income where these activities do not give rise to a foreign permanent establishment. Examples would be the passive holding of foreign assets such as bank deposits, shares (other than controlled foreign entity equity), or rental properties.

# TR 2002/D4

“**Average Australian assets**” is defined in section 820-37. It is an amount that has to be calculated in determining the application of the de minimis rule in section 820-37.

“**Commercial lending institution**” is not defined. Its meaning is important as it is necessary to determine what notional amount commercial lending institutions would reasonably be expected to have provided. The terms and conditions attaching to such an amount will also need to be the terms and conditions commercial lending institutions would impose. Refer to paragraphs 28 to 35 for the ATO interpretation of the phrase.

“**Controlled foreign entity debt**” is defined in subsection 995-1(1).

“**Controlled foreign entity equity**” is defined in subsection 995-1(1).

“**Debt capital**” is defined in subsection 995-1(1) to mean at a particular time, any debt interests issued by the entity that are still on issue at that time.

“**Debt deductions**” is defined in section 820-40. Debt deduction is defined very widely and embraces all the ordinary 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. The costs must be otherwise tax deductible (apart from the thin capitalisation rules).

“**Debt interests**” is defined in Subdivision 974-B of the ITAA 1997. A scheme gives rise to a debt interest in an entity if the scheme, when it comes into existence, satisfies the debt test in subsection 974-20(1) in relation to the entity. The debt test, and its application, is explained in the ATO’s “Guide to Debt and Equity” (Nat 4643). The Guide is located on the ATO website [www.ato.gov.au](http://www.ato.gov.au) under Business Tax Reform.

“**Entity**” is defined in section 960-100 to mean an individual, a body corporate, a body politic, a partnership, any other unincorporated association, a trust, or a superannuation fund.

“**In relation to the Australian business**” is a term used frequently in the context of the relevant factors, but is not defined. It emphasises the fact that the test has to be carried out, as far as possible, by reference to the facts and circumstances of the actual activities connected with Australia. In this way it defines and limits the fundamental hypothesis for determining the notional amount (the arm’s length debt amount).

“**Inward investing entity (non-ADI)**” is defined in subsection 820-185(2).

**“Maximum allowable debt”** is the maximum amount of debt capital giving rise to debt deductions permitted under the thin capitalisation rules. It is defined in sections 820-90 and 820-190.

**“Non-ADI”** means an entity that is not an ADI.

**“Outward investing entity (non-ADI)”** is defined in subsection 820-85(2).

**“Reasonably be expected”** is not defined in the legislation. Its meaning is important for applying the arm’s length debt test. The outcome of applying the arm’s length debt test is a determination of a hypothetical amount of debt capital that:-

would *reasonably be expected* to have been used to fund the Australian business;

and

independent commercial lending institutions would *reasonably be expected* to have been willing to lend.

Refer to paragraphs 36 to 38 for the ATO interpretation of this phrase.

**“Relevant factors”** are the factors listed in subsection 820-105(3) and subsection 820-215(3) and which must be taken into account for the purposes of determining an arm’s length debt amount.

**“Safe harbour debt amount”** is an amount that may be calculated by reference to the methods set out in section 820-95, section 820-100, section 820-195, section 820-200, section 820-205 and section 820-210 for the purpose of determining a taxpayer’s maximum allowable debt for an income year.

**“Worldwide gearing debt amount”** is an amount that may be calculated by the methods set out in section 820-110 for the purpose of determining an entity’s maximum allowable debt for an income year.

### **The thin capitalisation arm’s length debt test compared to other arm’s length tests**

7. While the exercise of determining the arm’s length debt amount is not a matter of pricing (and this distinguishes it from the arm’s length transfer pricing provisions in Division 13 of the ITAA 1936) the test is the same as other arm’s length tests in that it postulates what separate enterprises dealing with each other would do.

8. It is also consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations published in July 1995, where the application of the arm’s length principle is not just a matter of pricing but is used as a means of

# TR 2002/D4

determining the amount of debt capital of an enterprise (see paragraph 1.37 of the Guidelines).

9. The arm's length nature of the test requires that parts of multinational enterprises be deemed to be operating as separate entities rather than as inseparable parts of a single unified business.

10. Also it is essential to consider the commercial activities of the entity in connection with Australia: the economic value added by the functions performed, the assets and skills used, and the degree and nature of any business or financial risks involved.

11. There are at least three different methods by which an entity's financing strategies could be compared to arm's length benchmarks and whether these strategies make commercial sense:-

- External comparability - researching the funding and capital structures of comparable uncontrolled entities;
- Internal comparability - using as the relevant comparable the global/worldwide group (or sub-group) of which the Australian business is a constituent part; and
- The independent borrower/lender approach - using as a comparable an arm's length loan that would reasonably be expected to have been provided by independent commercial lending institutions and that the borrower would reasonably be expected to have borrowed.

12. Seeking to determine an arm's length capital structure by finding directly comparable companies may be an extremely resource intensive exercise fraught with practical problems.

13. Identifying the global group as the only relevant comparable will not always produce the appropriate outcome. Capital structures can be affected by local markets, economies and lending cultures. In any event, activities of an Australian business may not be comparable with the business of the group as a whole.

14. Using the analytical tools that an independent borrower/lender might reasonably be expected to use in determining the relevant funding is the method required by Division 820 in determining the arm's length debt amount.

## Date of Effect

---

15. This Ruling (and the new thin capitalisation regime) applies from the start of an entity's first year of income beginning on or after 1 July 2001.

## **Ruling and Explanation**

---

### **The approach of the new Thin Capitalisation regime**

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

17. The maximum allowable debt is the greatest of:

- the safe harbour debt amount;
- the worldwide gearing debt amount (only applicable to outward investors that are not foreign controlled); and
- the arm's length debt amount.

18. So, where adjusted average debt is higher than the safe harbour debt amount and the worldwide gearing debt amount (if applicable), the arm's length debt amount may determine an entity's maximum allowable debt for the purposes of the thin capitalisation regime.

19. The arm's length debt test will be satisfied where, considering the borrower's financial and economic circumstances:

- the entity's adjusted debt is no greater than the amount of debt that *the Australian business* would reasonably be expected to have; and
- the funds would have been provided as a loan (or a series of loans) by independent commercial lending institutions on arm's length terms.

20. In order to apply the arm's length debt test in the new thin capitalisation regime, it is necessary to identify and isolate an entity's commercial activities in connection with Australia (the Australian business).

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

22. Subsection (1) of these two sections introduces the concept of the arm's length debt amount and specifies the relevant tests. The amount in question is a notional or hypothetical sum determined according to the tests having regard to certain specified factual assumptions and relevant factors.

23. Subsection (2) of these two sections specifies the factual assumptions that must be taken into account in working out the notional amount. Subsection (3) of these two sections specifies the



**TR 2002/D4**

relevant factors that must be taken into account in determining whether the notional amount satisfies the tests in subsection (1).

24. The entity self assesses the arm's length debt amount in relation to its Australian business. However, by virtue of the power conferred under subsections 820-105(4) and 820-215(4), an alternative view of the outcome of the tests can be substituted if the Commissioner considers that the specified assumptions and relevant factors have not been properly taken into account.

25. The hypothesis featured in the provisions calls for a calculation of how much debt funding the Australian business would reasonably be expected to have under the assumptions and factors.

26. The hypothesis under subsections 820-105(1) and 820-215(1) is based on two related 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?
- What amount would independent commercial lending institutions reasonably be expected to lend under terms and conditions that would reasonably be expected if the lenders and the entity were dealing at arm's length with each other?

27. It is possible that the answer to each question may result in two different figures. However the legislation requires that the arm's length debt amount must satisfy both questions. While the legislation does not specifically address this situation, logically it follows that it is only the lesser of the two amounts which can satisfy both questions. Consequently in such circumstances the arm's length debt amount will be the lesser of the two figures.

**Commercial lending institutions**

28. "Commercial lending institution is not defined". Its meaning is important as it is necessary to determine what notional amount commercial lending institutions would reasonably be expected to have provided. The terms and conditions attaching to such an amount will also need to be the terms and conditions commercial lending institutions would impose.

29. As is made clear in the explanatory memorandum ("the EM") introducing the thin capitalisation regime, at paragraph 10.32

*"The terms of the loans actually transacted and entered into will usually be the starting point for an arm's length debt*

*analysis, and any amendment to them would only be made in exceptional cases and would need to be clearly justifiable.”*

30. In accepting the actual terms and conditions that commercial lending institutions would have used, the phrase “commercial lending institution” is to be given a broad meaning. It is considered the words “commercial” and “lending” have a generally accepted meaning. The meaning of “institution” is not so clear. Court cases that have looked at the meaning of the word “institution” have often resorted to the dictionary meaning. For example, Gibbs J in *Stratton v. Simpson* (1970) 125 CLR 138 at 158; [1971] ALR 117 at 128 where his honour said:

*“...in its ordinary sense ‘institution’ means an establishment, organisation or association instituted for the promotion of some object, especially one of public utility, religious, charitable, educational etc (the shorter Oxford English Dictionary).”*

31. In the context of the arm’s length test it would be incorrect to confine commercial lending institutions simply to banks. It would 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. For instance, if the entity raised debt capital, on arm’s length terms and conditions, from the bond market, it would be accepted that this debt capital has been provided by a commercial lending institution.

32. As indicated in the EM, including at paragraph 10.33, it would **not** be acceptable for an entity to alter the actual transaction and create another hypothetical transaction based on what the entity could have done if it had borrowed from another type of commercial lending institution.

33. For instance, if the entity had borrowed at arm’s length from a bank it would not be acceptable for the entity to adjust this actual transaction and replace it with what would have happened if it had borrowed from the bond market or some other commercial lending institution.

34. If the entity borrowed from its parent and each of the debt capital terms and conditions were the same or similar to what a commercial lending institution would have imposed, then there would be no justification to change those terms and conditions.

35. When evaluating what commercial lending institutions would reasonably be expected to provide it is necessary to take into account certain factual assumptions. Refer to paragraphs 39 to 41.

## **Reasonably be expected**

36. The term “reasonably be expected” is not defined in the legislation. The term “reasonably expected” has been judicially considered on a number of occasions and the settled meaning may be found in *FC of T v. Peabody* 94 ATC 4663 at 4671; 28 ATR 344 at 353 where the High Court said that:-

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

37. While this statement was made in the context of the interpretation of provisions of Part IVA of the ITAA 1936, it is considered that the meaning adopted by the Court is equally applicable to the use of the term in the thin capitalisation regime.

38. In evaluating how the investor and lender are reasonably likely to behave with respect to their financial dealings, regard will be had to commercial norms and generally accepted industry behaviours and practices. The standard of the test prescribed is higher than a prediction of a possible level of debt to fund the Australian business, the amount of debt giving rise to debt deductions must be a reasonably likely or expected position having regard to the legislative requirements.

## **Nature of the factual assumptions**

39. The factual assumptions serve to define and prescribe the setting for working out the arm’s length debt amount.

40. The assumed conditions are based on what actually happened in relation to the Australian business during the period, with some modification where required regarding the status of the lender and basis of security over borrowings by the entity in relation to its Australian business.

41. The combination of the factual assumptions creates the basis on which the arm’s length analysis must be conducted. The scenario developed is one which would exist if the entity had been dealing with independent commercial lending institutions, without the credit support of related parties. Under that scenario, it is assumed that the entity and the notional commercial lending institution will only consider the assets and income of the entity’s Australian business when conducting the required analysis.

**Nature of the relevant factors**

42. The relevant factors are intended to reflect the considerations that might be expected to be taken into account by an independent person that was contemplating the appropriate mix of equity and debt capital for funding their business. They also reflect what an independent commercial lending institution would consider when contemplating whether it would provide loan funding for that business, and if so, how much it might lend. The relevant factors must be considered in the context of the prescribed factual assumptions and must be taken into account in determining whether the arm's length debt amount satisfies the two conditions in subsections 820-105(1) and 820-215(1) (see paragraph 26).

43. The relevant factors are interrelated. For example, the terms and conditions that apply to the entity's debt capital for a period have a direct effect on the profitability of the entity (including the return on its equity) for a period and on its capacity to repay all of its liabilities that are due to be paid during the period.

44. Determining the arm's length debt amount is an exercise that needs to be carried out from the perspective of both the borrower and independent commercial lending institutions. This is because while paragraphs 820-105(1)(a) and 820-215(1)(a) look for the amount of debt that would have been borne by an independent borrower carrying on the entity's Australian business, paragraphs 820-105(1)(b) and 820-215(1)(b) look at what independent commercial lending institutions might reasonably have done.

45. Whilst the legislation prescribes factors that must be taken into account, some factors will be particularly important for a borrower while others will be particularly important for the lender. The weight given to each factor in the analysis of the Australian business will therefore vary, depending on the facts and circumstances of the case.

46. All of the relevant factors must be taken into account in determining this notional amount. However, this does not mean that every single factor will have a material impact on the quantum of the arm's length debt amount.

47. From the borrower's perspective, it is important to consider the appropriate gearing level of its Australian business. For example, it would not be reasonable to expect a borrower to be so debt laden that it could not provide an adequate return on equity invested in its Australian business.

48. From the lender's perspective, the legislation requires the arm's length debt amount to be representative of transactions that independent commercial lending institutions would have carried out. In general, the test looks at the total debt from all providers throughout the income tax year.

# TR 2002/D4

49. There is also the flexibility to examine the relevant factors at the time a particular loan was made, in appropriate cases. While the determination of an arm's length amount must be done annually, the relevant factors in paragraphs s820-105(3)(k) and 820-215(3)(j) allow the factors that existed at the time that debt capital was last raised, to be considered. The EM at paragraph 10.56 states:

*“The purpose of adopting this factor is to eliminate the compliance burden of doing a comprehensive arm's length analysis every year when it is clear that nothing has materially changed.”*

The EM further states at paragraph 10.57:

*“Examples of where this may be useful could include situations where the only change is a decrease in the accounting value of the assets or where there has been a negative movement in the exchange rates that impacts on asset or liability values.”*

## **A suggested step-by-step methodology**

---

50. The six major steps outlined in the following methodology provide a way of applying an independent borrower/lender approach for determining the arm's length debt in practice. Further guidance and an example of how the various factors may be evaluated is provided later in the Ruling.

51. The six steps are:

**Step 1**

**Identify and define the “Australian business” of the entity**

**Step 2**

**Determine the net operating assets, cash flows and profits in relation to the Australian business**

**Step 3**

**In relation to the debt capital of the entity attributable to the Australian business, identify conditions modifying the circumstances under which the Australian business was actually carried on**

**Step 4**

**Determine the amount of debt capital giving rise to debt deductions that the Australian business of the entity would reasonably be expected to have throughout the year**

**Step 5**

**Determine the amount of debt capital that commercial lending institutions dealing with the entity at arm’s length would reasonably be expected to provide throughout the year**

**Step 6**

**Determine the Arm’s Length Debt Amount**

52. Under this methodology, steps 1 to 3 involve the data collection and analysis required for the making of the factual assumptions under subsections 820-105(2) and 820-215(2). Steps 4 and 5 are directed at the consideration of the questions in paragraphs (1)(a) and (1)(b) respectively of those sections. They incorporate the additional data collection and analysis for establishing the relevant factors listed in subsection (3) of those sections. Step 6 is the determination of the notional amount (the arm’s length debt amount), having regard to the requirement that the amount must satisfy both tests under subsection (1) of those sections. In the event that the

# TR 2002/D4

amount under each test is different, the lesser amount will be the arm's length debt amount.

## Step 1 Identify and define the "Australian business" of the entity

Identify and define the commercial activities carried on by the entity during the year of income.

Identify which of those commercial activities were connected to Australia.

For outward investing entities identify and exclude -

- holdings of associate entity debt;
- holdings of controlled foreign entity debt;
- holdings of controlled foreign entity equity; and
- any business carried on by the entity at or through its overseas permanent establishments.

For inward investing entities identify and exclude -

- holdings of associate entity debt.

Identify the nature of the Australian business assets and liabilities and the circumstances under which the Australian business was carried on.

## Explanation of Step 1

53. Step 1 is an analysis of the commercial activities of the entity in order to establish those activities which are connected with Australia during the relevant period. A functional analysis of the entity is likely to assist in this regard.

54. To identify the Australian business the following may be important:

- a history of the entity's business;
- the activities and functions undertaken by the entity;
- a detailed break down of the different parts of the entity;

- the economically important activities undertaken by the entity;
- the resources used and the risks assumed;
- a detailed break down of the assets that are held or used by the entity; and
- an assessment of the commercial context in which the entity is operating.

55. What constitutes an Australian business is discussed under **“key concepts and definitions”** after paragraph 6. Holdings of associate entity debt, controlled foreign entity debt, or controlled foreign entity equity are excluded from the Australian business as required by subparagraphs 820-105(2)(a)(ii) and 820-215(2)(a)(ii). The commercial activities associated with such holdings are also excluded. For example, the income and expenses directly associated with these holdings must also be identified and eliminated when income, profits and cash flow levels are being evaluated for the purposes of the arm’s length debt test.

56. The provisions introduce assumptions that govern the nature of the business and the circumstances under which it was carried on. In particular, it is specified that the entity carried on the Australian business that it actually carried on, and its assets and liabilities were those that it actually had that were attributable to the Australian business. It is therefore necessary to identify the entity’s assets and liabilities attributable to the Australian business, assuming that it carried on the business that it actually carried on during the year.

57. It is also necessary to assume that this business was carried on in the same circumstances that actually existed during the year with two exceptions:

- it is to be assumed that the actual circumstances apply, subject to modification to accommodate the hypothesis concerning the willingness of commercial lending institutions to provide debt capital to the business; and
- without credit support from associates or the use of assets not attributable to the Australian business as security.

58. In order to completely identify the Australian business and its commercial activities, assets and liabilities and the relevant circumstances, the functional analysis of the Australian business, as required by the relevant factors,<sup>2</sup> may assist.

59. It is important to note that for an outward investing entity the Australian business will also include commercial activities that give

---

<sup>2</sup> Paragraphs 820-105(3)(a) and 820-215(3)(a).



# TR 2002/D4

rise to foreign source income where these activities are not carried on through a foreign permanent establishment. Examples would be the passive holding of foreign assets such as shares (other than controlled foreign entity equity), bank deposits or rental properties.

## **Step 2 Determine the net operating assets, cash flows and profits in relation to the Australian business**

Prepare a statement of net operating assets attributable to the Australian business. This identifies the assets less the non-debt liabilities attributable to the Australian business.

Prepare cash flow statements and statements of financial performance (profit and loss statement) for the Australian business showing profit from operations (Earnings Before Interest and Tax, "EBIT").

### **Explanation of Step 2**

60. The action under step 2 seeks to identify the Australian business in financial terms. This methodology involves assembling the following information:

- the assets and non-debt liabilities attributable to the Australian business; and
- income, expenses, profits and cash flow of the Australian business.

61. The arm's length debt analysis looks to the Australian business as the source of funds to service the costs associated with debt capital. The focus is on the nature and quality of the assets that are used to generate profits and cash flows, as well as providing comfort to the lender for the provision of debt capital.

62. The entity's accounts will normally be the starting point for the preparation of a statement of financial performance for the Australian business and the existing accounts will usually provide much of the relevant data for the critical aspects of the test.

63. Where the Australian business comprises all the commercial activities of the entity, there will be no need to prepare any additional income statements specifically for the arm's length debt test. In other cases it may only be necessary to adjust existing statements. A statement of financial performance and a statement of source and application of funds may assist to undertake the evaluation of profits and cash flows under the further steps below.

**Step 3 In relation to the debt capital of the entity attributable to the Australian business, identify conditions modifying the circumstances under which the Australian business was actually carried on**

Identify debt capital provided respectively by commercial lending institutions and by associates of the entity.

Identify debt capital supported by any guarantee, security or other form of credit support provided by associates, or by the use of assets of the entity attributable to its overseas permanent establishments.

Identify the terms and conditions of the debt capital that are not arm's length.

**Explanation of Step 3**

64. This step addresses the factual assumptions that specify two fundamental conditions in relation to the raising of the entity's debt capital for its Australian business. Firstly, the arm's length analysis is to be conducted on the basis that the entity's debt capital is provided by commercial lending institutions, that are not associates of the entity, on arm's length terms. Secondly, it requires the arm's length analysis to be conducted on the basis that any guarantee, security or other credit support provided by associates or other parts of the entity are taken not to have been received by the entity during the year. Refer to paragraphs 820-105(2)(d) and 820-215(2)(d).

65. These two particular factual assumptions require the analysis to be conducted on the basis of notional or hypothetical conditions that replace what actually happened during the year.

66. The starting point for determining the arm's length debt amount will generally be the terms and conditions of the actual debt capital. Where relevant terms and conditions are not arm's length, it will be necessary to use arm's length terms and conditions.

**Step 4 Determine the amount of debt capital giving rise to debt deductions that the Australian business of the entity would reasonably be expected to have throughout the year**

Identify the relevant features of the debt attributable to the Australian business, including:

- the purpose for which the debt was entered into;
- the terms and conditions; and
- security over assets attributable to the Australian business.

Conduct an evaluation of the Australian business:-

- functions performed, assets used and risks assumed;
- nature of, and title to, assets available as security for its debt capital;
- profitability and return on capital;
- debt to equity ratio; and
- capacity to meet all its liabilities.

Collect and evaluate comparative data with respect to:

- how other activities of the entity were financed;
- debt to equity ratio of entity;
- debt to equity ratio of associates engaged in similar commercial activities to the Australian business; and
- commercial practices of independent entities in the same industry (whether in Australia or comparable overseas markets) as the Australian business.

Evaluate any material impacts of the state of the Australian economy.

**Explanation of Step 4**

67. The fourth step considers the question in paragraphs 820-105(1)(a) and 820-215(1)(a).

68. Essentially, the question to be determined is the amount of debt capital attributable to the Australian business that would reasonably be expected under the factual assumptions, having regard to the factors listed in subsections 820-105(3) and 820-215(3).

69. The analysis assumes that the entity in relation to the Australian business undertook the same activities, had available to it the same resources and faced the same risks. In a practical sense, it is assumed that it dealt with the same customers and suppliers, faced the same competitors and had the same management with its approach to risks. The analysis also has to take into account the capacity of the Australian business to borrow without any guarantee, security, or credit support provided by associates, and without the use of assets attributable to the entity's overseas permanent establishments.

70. Application of the relevant factors is discussed in depth below under the heading '**Applying the test in practice**'.

**Step 5 Determine the amount of debt capital that commercial lending institutions dealing with the entity at arm's length would reasonably be expected to provide throughout the year**

Revisit factors under Step 4 from the perspective of independent commercial lending institutions performing a credit evaluation of the Australian business.

**Explanation of Step 5**

71. The fifth step considers the question in paragraphs 820-105(1)(b) and 820-215(1)(b). This involves a reconsideration of the factors under the four headings at step 4 from the perspective of a commercial lending institution that is not an associate of the entity. Refer to paragraphs 28 to 35 for the ATO interpretation of meaning of commercial lending institutions in the thin capitalisation context.

72. A commercial lending institution would reasonably be expected to undertake a credit evaluation to determine its lending policy towards an entity's Australian business. The credit evaluation would typically involve an assessment of the following:

- The purpose of the borrowing and sources of repayment;

# TR 2002/D4

- The current risk profile (including the nature and aggregate amounts of risks) of the borrower and collateral, and its sensitivity to economic and market developments;
- The borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections, under various scenarios;
- The borrower's business expertise and the status of the borrower's economic sector and its position within that sector; and
- The proposed terms and conditions of the debt capital, including covenants designed to limit changes in the future risk profile of the borrower.

73. A commercial lending institution is also likely to consider the assets of the Australian business, its cash flows and ability to repay the loan, having regard to its performance, liquidity and other liabilities. The commercial practices specific to the relevant industry, and the general state of the Australian economy during the year are also likely to be considered.

74. Application of the relevant factors is discussed under the heading '**Applying the test in practice**'.

## Step 6 Determine the Arm's Length Debt Amount

Arm's length debt amount is the lesser of the amounts under step 4 and step 5.

### Explanation of Step 6

75. The final step is determining the notional amount having regard to the processes under steps 4 and 5. The legislation requires that the notional arm's length debt amount be an amount that would be borrowed (as determined under step 4) and lent (as determined under step 5). The only figure which could satisfy both steps 4 and 5, if the amounts differ, is the lesser of the two amounts.

## Applying the Test in Practice

### The context

76. The arm's length debt amount may be more or less than the safe harbour debt amount and/or the worldwide gearing debt amount.

77. However, broadly speaking, the level at which the safe harbour debt amount has been set means that an entity will have to consider the arm's length debt test only where its Australian business is geared at more than the safe harbour debt amount.

78. Independent commercial lending institutions are unlikely to lend significantly in excess of 75% of the net asset values, especially without credit support from associates, unless there are other specific factors present to give high levels of comfort/security. As a result, the application of the arm's length debt test in practice is likely to focus on levels of income, profits and cash flows (historic, current and projected) relative to the debt capital. In most cases, therefore, it is only the existence of particularly strong levels of pre-interest profits or cash flows that could support these high levels of debt capital.

79. Independent commercial lending institutions would normally expect borrowers to have adequate income to comfortably service their debt obligations.

80. Borrowers would usually be expected to generate an adequate level of post-interest profit (i.e., return on the capital invested) to assist in funding their capital expenditure requirements as well as provide for distributions to their owners.

## **Evaluation of the debt**

### ***Terms, conditions and purpose of the debt capital***

81. Not only does the arm's length debt amount represent an amount that would reasonably be expected to have been provided by an independent commercial lending institution, it is further required that it be provided on terms and conditions that would reasonably be expected to have applied if the parties had been dealing at arm's length.

82. The focus is on the actual debt provided. The terms of the loans actually transacted and entered into will be the starting point for the arm's length debt analysis unless the terms and conditions are not at arm's length. If a term or condition is not what would reasonably be expected between an independent borrower and independent commercial lending institutions then adjustments or amendments may be justified.

83. Some cases may attract the joint operation of the thin capitalisation rules and the transfer pricing rules in Division 13 of Part III of the *ITAA 1936* and comparable provisions of Australia's double tax agreements.

84. The transfer pricing provisions in Division 13 can operate to adjust profits where loans are not on arm's length terms (an excessive interest rate, for example). In these cases, the arm's length terms and

conditions established under Division 13 will be used when conducting the arm's length analysis under the thin capitalisation regime. The inter-relationship between thin capitalisation rules and transfer pricing provisions is discussed in detail at paragraphs 1.74 to 1.79 of the EM introducing the new thin capitalisation regime.

85. The existence of non-arm's length terms and conditions may not always result in a transfer pricing adjustment to taxable profits. Nevertheless, in these circumstances, the arm's length debt amount still needs to be quantified on the basis of terms and conditions that would reasonably be expected to have applied at arm's length, rather than the actual terms and conditions.

86. The purpose and nature of the borrowing will be influential in determining the arm's length amount. For example, the terms of the loan sought (i.e., whether it is short, medium or long term) and whether the loan is to fund working capital requirements or to acquire a fixed asset will impact on what are arm's length terms and conditions and the nature of any assets that may be required to support the loan.

## **Evaluation of the Australian business**

### ***Functional analysis***

87. Determining the arm's length debt amount requires, amongst other relevant factors, a consideration of the functions performed, the assets used and the risks assumed by the Australian business.

88. A functional analysis is useful to identify such factors as:-

- the markets in which the business operates;
- the nature of the business;
- the size of the business;
- its market share;
- the degree of competition;
- income, expenses, cash flows – past, present and estimated;
- industry norms; and
- the stability of returns.

89. Depending on the functions performed, the entity may require short terms funds for working capital or longer terms funds for the acquisition of assets. If the debt is intermediate or long term, a borrower could expect that the value of fixed assets is likely to be more significant for the purposes of obtaining the loan.

***The nature of, and title to, assets available as security***

90. A functional analysis would also identify and value those assets that are available as security for debt capital. An independent commercial lending institution is likely to be particularly concerned about the borrower's ability to repay. Usually it is only when the lender is satisfied in this regard that it would look to the quality of assets available to support a loan.

91. Goodwill is not normally an asset that can be used to secure debt capital. The real value of goodwill is effectively taken into account under the arm's length debt test by way of historical and projected income/profit levels.

92. Where profit ratios, rather than cash flow cover ratios are being used, it may be appropriate to add back the amortisation of purchased goodwill in calculating earnings levels.

93. The purpose of security is to provide insurance so that the lender can liquidate the asset if the borrower defaults. Assets that cannot be easily liquidated, for example goodwill, will have limited value as security. An independent commercial lending institution would usually be concerned with the liquidated value of the assets rather than the book or historical values.

***Profitability, return on capital, debt equity ratios and capacity to meet liabilities***

94. The relevant factors require that the profitability, return on capital, debt to equity ratio and the capacity to meet liabilities of the Australian business need to be assessed. In the arm's length context it would be reasonable for the borrower and commercial lending institutions to expect the Australian business to be earning sufficient profit and cash flow to cover its expenses, including tax and the capacity to meet its debt repayment obligations as well as generate an adequate return to its owners.

95. Independent commercial lending institutions are, in general, unlikely to be comfortable with a business being geared in excess of 75% of the net asset values unless the pre-interest profit, or Earnings Before Interest and Tax ("EBIT"), comfortably covers the interest expense. Alternatively they might look for cash flow cover, typically based on Earnings Before Interest, Tax, Depreciation and Amortisation ("EBITDA"). To compensate for the increased risk associated with high gearing, independent commercial lending institutions might look for correspondingly increased levels of income/cash flow. This may be the case in some industries such as the services industry, which may have a low level of tangible assets but high cash flows.



**TR 2002/D4**

96. Independent commercial lending institutions might also look to cash flow statements to support the borrower's capacity to have sufficient funds to meet their debt obligations and provide a return to its owners.

97. Determining which ratios are most significant will depend on the nature of the business in question, as well as its depreciation and capital expenditure profile. The relevant factors require that the return on capital be taken into account. The use of cash flow or EBITDA ratios is only likely to be appropriate where the annual depreciation is greater than capital expenditure on replacement assets.

98. Even where it is appropriate to use income cover multiples calculated by reference to cash flow or EBITDA, independent commercial lending institutions are unlikely to ignore the gearing aspect in most cases. They will generally stipulate some figure of net worth they would like to be maintained or bettered and, more importantly, they could reasonably be expected to tie the amount of debt (as well as the debt costs) to the cash flow or EBITDA.

99. So for entities geared in excess of 75%, in addition to minimum profit/cash flow cover ratios, prudent independent commercial lending institutions might expect a maximum Debt/EBIT or Debt/EBITDA ratio.

100. The following example demonstrates how an arm's length lender might use debt cover to establish debt amount limits (assume the ratios are based on industry and market place data).

EBITDA of the Australian Business	100
Depreciation of assets used in the Australian Business	25
EBIT of the Australian Business	75
Average interest rate for the year (as charged to the entity or, if non arm's length, the rate that would reasonably be expected to have applied at arm's length)	6.5%

For a business geared in excess of 300% debt to equity, independent commercial lending institutions might, for example, require:

- Minimum EBIT cover of 4.0; and
- Maximum Debt/EBIT ratio of 4.5.

EBIT cover requirement	4.0
Debt/EBIT ratio requirement	4.5
Debt amount producing EBIT cover of 4.0	288
Debt amount producing Debt/EBIT ratio of 4.5	338

**TR 2002/D4**FOI status: **draft only - for comment**

Page 25 of 36

<b>Arm's Length Debt Amount (i.e., the lower amount)</b>	<b>288</b>
EBIT cover (arm's length debt amount)	4.0
Debt/EBIT ratio (arm's length debt amount)	3.8

Or, if EBITDA is a more appropriate measure of income, independent commercial lending institutions might for example require:

- Minimum EBITDA cover of 5.5; and
- Maximum Debt/EBITDA ratio of 2.5.

EBITDA cover requirement	5.5
Debt/EBITDA ratio requirement	2.5
Debt amount producing EBITDA cover of 5.5	280
Debt amount producing Debt/EBITDA ratio of 2.5	250
<b>Arm's Length Debt Amount (i.e., the lower amount)</b>	<b>250</b>
EBITDA cover (arm's length debt amount)	6.2
Debt/EBITDA ratio (arm's length debt amount)	2.5

101. There may be cases where the immediate existence of exceptional profits may not be expected. For example:

- activities which, typically at arm's length, are highly geared (e.g., leasing); and
- special situations (start-ups and the period immediately following a third party acquisition).

102. Financial businesses (non-ADIs) are special cases too, and the legislation reflects this in the safe harbour rules for financial entities and in the identification of zero-capital amounts.

103. Of course independent commercial lending institutions also apply different criteria when lending to financial businesses. Where the risks associated with the activities of a financial business are low enough to justify very low capital requirements, independent commercial lending institutions are likely to focus mainly on the adequacy of the margin or "turn". In other cases a minimum equity (or gearing) level is also likely to be required.

104. Where the entity uses the grouping rules in the thin capitalisation regime and the group contains both financial and non-financial entities, it will generally be appropriate, when conducting the arm's length debt test, to carve out and treat separately the financial businesses. Nevertheless, a single arm's length debt amount for the group, considering the mixture of the group's business, would be required.

## **Collection and Evaluation of comparative data**

### ***Debt to equity ratio of the entity, and of associates***

105. The debt to equity ratio of the entity and of associates in the same industry may be illustrative of what the arm's length ratio should be for the Australian business. This is not to deny that there may be reasons for the differing ratios. Where there is a variation it is expected that such differences can be explained and justified.

### ***Commercial practices of parties in the same industry***

106. Commercial practices in the industry in which the Australian business operates may be an important indicator of whether independent commercial lending institutions would lend at a particular time and for a particular purpose. Independent commercial lending institutions may apply different lending criteria to different industries. Where the Australian business is geared in excess of 75% findings that the industry typically has such high gearing will be strong evidence in support of such gearing.

107. For example, it is not unusual for the leasing industry or the public infrastructure industry to be geared in excess of 75% of net assets. However, industry practices themselves need to evidence the kind of arm's length behaviour that is required in this analysis before being used as a benchmark. It will still be necessary for the Australian business of the entity operating in such an industry to establish in accordance with the assumptions and other relevant factors that it could sustain such a high level of debt.

108. On the other hand, those Australian businesses in an industry which have gearing levels much lower than 75% should be able to establish that they have special circumstances that justify a gearing level higher than the rest of the industry.

109. Public or industry information indicating the gearing or commercial practices of the industry will be of assistance in evaluating this relevant factor.

110. Where the entity is an outward investing entity the way the entity financed its non-Australian business may be useful in determining the arm's length amount. Where its foreign business carries on comparable activities and are geared similarly to the Australian business it may support a conclusion that the Australian business is appropriately geared.

**Evaluate any impact of the Australian economy**

111. Most lenders and borrowers would have an eye to the economy when providing or seeking a loan. For instance, the current economic climate and expectations for the future affect confidence levels which may in turn influence financing and lending decisions. The existence and expectation on such matters as recessions, booms, interest rate changes and credit squeezes may affect the capacity to lend and borrow. It will be necessary to evaluate the impact that the state of the economy may have in determining the arm's length debt amount for the Australian business.

**Use of measurement days and the arm's length debt test**

112. The arm's length debt test requires the calculation of a notional amount of debt capital that the entity would reasonably be expected to have throughout the income year. When this notional arm's length debt amount is the maximum allowable debt it is compared to the adjusted *average* debt. The average is determined through the use of measurement days, as provided for in Subdivision 820-G.

113. In determining the notional arm's length debt amount that the entity would reasonably be expected to have throughout the year, the use of measurement days (under subdivision 820-G) can be employed where appropriate. Where there are significant and material changes in the Australian business or to the factors (including debt levels) throughout the year, then the arm's length debt amount may need to be calculated for different periods and then averaged.

.

**Groups**

114. Where associated entities decide to exercise the option to group under Subdivision 820-F, the Australian businesses of the grouped entities will be amalgamated and treated as divisions or parts of a single notional entity for the purposes of applying the arm's length debt test. The amounts being considered (debt, equity, income etc) should be calculated in accordance with the accounting standard on consolidated accounts.

115. The Government on 7 February 2002, released a draft copy of legislation on consolidation. The Treasurer's Press Release 38, dated 22 May 2001, stated that "*the deferral of the consolidation regime has led to the need for some form of grouping to be included in the thin capitalisation rules as an interim measure.*"

116. Where related companies cannot, or do not, exercise the grouping option, the independent borrower/lender approach should be applied to the individual entity without taking into account the Australian business of any associates.

# TR 2002/D4

117. The only exception is where associate entity equity, that is not controlled foreign entity equity, is held. Even where a grouping election has not been made, it is appropriate to follow the practice of independent commercial lending institutions in “looking through” the equity held to the actual assets represented by the equity. This approach enables an Australian parent company’s arm’s length debt capacity to be evaluated by reference to the Australian business carried on by its subsidiary.

118. But it is also important to consider the liabilities and gearing of the entities held. The “looking through” approach should be balanced by the need for the borrower’s debt capacity to be determined on a stand alone basis.

## Information and Documentation

119. Whatever methodology has been used to calculate the arm’s length debt amount, section 820-980 requires the keeping of records. Section 820-980 requires the records to contain particulars about the factual assumptions and relevant factors that have been taken into account in working out the arm’s length debt amount.

## Example

---

### Example showing the application of the step – by – step methodology outlined in the ruling

120. The entity is an Australian company which is foreign owned. Its business consists of trading in processed or partly processed raw material products. It also wholly owns an overseas subsidiary. The entity has borrowed \$225 million from an Australian bank which is secured over the entity’s assets and supported by guarantees from its parent company. The terms and conditions of the loan are arm’s length. The Australian business is consistently profitable, notwithstanding fluctuating returns due to the cyclic nature of the industry. There have been no significant or material changes to the company's business throughout the year.

*The statement of financial position (balance sheet) of the entity is as follows:*

<u>Assets</u>		<u>Liabilities</u>	
Current	\$48m	Non-debt Liabilities	\$20m
Non Current	\$112m	Loans	\$225m
CFE Equity	\$150m	Paid up capital	\$15m
		Retained earnings	\$50m

The Statement of financial performance for the entity is as follows:

Sales	\$180m
Cost of Sales	\$122m
Gross Profit	\$58m
CFE Dividend	\$20m
Expenses	\$36m
EBIT	\$42m
Interest	\$14m
Net operating profit	\$28m

### **Step 1**

#### ***Identify and define the Australian business of the entity***

121. A functional analysis of the entity will usually assist in identifying what parts of the entity would constitute the Australian business.

The commercial activities connected with Australia will constitute the Australian business. The entity is involved in two functions: trading in raw materials in Australia and the holding of controlled foreign entity equity. The former is connected to Australia and the latter is not.

The Australian business cannot include the holding of controlled foreign entity equity and must be disregarded. The activities associated with the holding of such assets, for example the income and expenses must also be disregarded for the purpose of the arm's length debt analysis.

The legislation requires the assumption that the entity carried on the Australian business that it actually carried on during the year, and in the same circumstances that actually existed.

# TR 2002/D4

## Step 2

### ***Determine the net operating assets, cash flows and profits in relation to the Australian business***

122. Step 2 is closely aligned with step 1 and in practice there may be some overlap. While step 1 identifies the Australian business, step 2 identifies the financial position of the Australian business. In this example, the statement of financial position of the Australian business, would be the entity's statement, modified to exclude the controlled foreign entity equity (the CFEE).

The \$310 million of assets, as shown in the balance sheet, would be reduced by \$150 million to \$160 million. For the purposes of the example it is assumed all the non-debt liabilities are attributable to the Australian business. In an actual case this issue would be a matter to be established by looking at the particular facts.

To establish the statement of financial performance for the Australian business, the entity's statement can be modified to exclude the dividend from the CFEE and any expenses that have been incurred in deriving that income. It is assumed that \$400,000 of other expenses are related to holding the CFEE.

The profit and loss excluding debt deductions would be:

Gross profit	\$58m
Expenses	\$35.6m
EBIT	\$22.4m

In practice a cash flow statement in respect of the Australian business would usually be prepared.

The net operating assets of the entity's Australian business are \$140 million, being \$160m assets less non-debt liabilities of \$20 million.

## Step 3

### ***In relation to the debt capital of the entity attributable to the Australian business, identify conditions modifying the circumstances under which the Australian business was actually carried on***

123. The starting point for determining the arm's length debt amount will usually be the terms and conditions of the actual debt capital. Where relevant terms and conditions are not arm's length, it will be important to use arm's length terms and conditions. In this example, the debt capital of \$225 million has been borrowed at 6.2% from an independent commercial lending institution and there is nothing to suggest the terms and conditions are not consistent with normal arm's length dealings.

However, the modifying assumptions need to be considered. It is necessary to identify those terms and conditions where there is credit support from associates, or by the use of assets that are not part of the Australian business.

In this example, there are guarantees provided by the foreign parent and there are non-Australian business assets (the CFEE) used as security.

#### **Step 4**

***Determine the amount of debt capital giving rise to debt deductions that the entity's Australian business would reasonably be expected to have throughout the year***

124. As shown in step 3, the terms and conditions of the debt capital are arm's length and no modification apart from ignoring the parental guarantee and controlled foreign entity (CFE) assets as security is required. The analysis can then proceed to determine the arm's length debt amount using the terms and conditions of the actual debt capital.

Assume that the adjusted average debt throughout the year is \$225 million. If the arm's length debt amount were to be determined as \$225 million then the thin capitalisation rules would not disallow any debt deductions.

In the absence of the parental guarantee and CFE assets security it would be reasonable to expect that an independent commercial lending institution would require the assets of the Australian business as security. In this example the Australian business has net assets valued at \$140 million.

Market and industry data, including the terms of the loan to the entity indicate interest cover of one third EBIT is the norm. This would suggest interest payments of around \$7.4 million could be sustained by the Australian business. Assuming that the interest rate of 6.2% is arm's length then an arm's length debt amount of around \$120 million would result using this as a guide.

The net profit with that level of debt would be -

EBIT	\$22.4m
Interest	\$7.44m
Net Profit	\$14.96m

The loan terms and conditions of the actual loan indicate that repayments of principal on a loan of \$120 million would be around \$12 million decreasing every year after that.



# TR 2002/D4

The profit indicates that the Australian business has the capacity to repay the interest and principal and provide a dividend to the shareholders.

These relevant factors suggest the arm's length debt amount would be in the region of \$120 million.

Assuming that, when all the assumptions and relevant factors are taken into account, it would be reasonable to expect that the entity in relation to its Australian business would have debt capital of no more than \$120 million.

## Step 5

***Determine the amount of debt capital that commercial lending institutions dealing with the entity at arm's length would reasonably be expected to provide throughout the year***

125. To a large degree there will be an overlap in the analysis carried on by the borrower and the lender. An independent commercial lending institution would not lend without doing a similar analysis as required by step 4.

When an independent commercial lending institution is satisfied that the borrower can meet the repayment obligations, it will then look to the assets of the borrower as protection against default.

Assume that an examination of the loan shows a covenant that the entity is to maintain net assets so that the value of the loan is no more than 80% of the value of the assets. This accords with market and industry practice.

The net assets are \$140 million, 80% of which is \$112 million. It would be reasonable to expect that an independent commercial lending institution would not lend more than \$112 million.

## Step 6

***Determine the Arm's Length Debt Amount***

126. As explained in paragraphs 26 and 27 the arm's length debt amount is the lesser of the amounts under step 4 and step 5. In this case it would be \$112 million. Therefore, the arm's length debt amount of the entity is \$112 million.

This amount is compared to the adjusted average debt. In this example the adjusted average debt of the entity is \$225 million and the excess debt amount is therefore \$113 million.

## Detailed contents list

127. Below is a detailed contents list for this draft Ruling:

	<b>Paragraph</b>
<b>What this Ruling is about</b>	<b>1</b>
Thin Capitalisation and the Arm's Length Debt Amount	1
Class of persons/arrangements	4
Key concepts and definitions	6
The thin capitalisation arm's length debt test compared to other arm's length tests	7
<b>Date of effect</b>	<b>15</b>
<b>Ruling and Explanation</b>	<b>16</b>
The approach of the new Thin Capitalisation regime	16
Commercial lending institutions	28
Reasonably be expected	36
Nature of the factual assumptions	39
Nature of the relevant factors	42
<b>A suggested step-by-step methodology</b>	<b>50</b>
Explanation of Step 1	53
Explanation of Step 2	60
Explanation of Step 3	64
Explanation of Step 4	67
Explanation of Step 5	71
Explanation of Step 6	75
<b>Applying the Test in Practice</b>	<b>76</b>
The context	76
Evaluation of the debt	81
<i>Terms, conditions and purpose of the debt capital</i>	81
Evaluation of the Australian business	87
<i>Functional analysis</i>	87
<i>The nature of, and title to, assets available as security</i>	90
<i>Profitability, return on capital, debt equity ratios and capacity to meet liabilities</i>	94
Collect and evaluate comparative data	105

**TR 2002/D4**

<i>Debt to equity ratio of the entity, and of associates</i>	105
<i>Commercial practices of parties in the same industry</i>	106
Evaluate any impact of the Australian economy	111
Use of measurement days and the arm's length debt test	112
Groups	114
Information and Documentation	119
<b>Example</b>	<b>120</b>
Example showing the application of the step - by - step methodology outlined in the ruling	120
Step 1	121
<i>Identify and define the "Australian business" of the entity</i>	121
Step 2	122
<i>Determine the net operating assets, cash flows and profits in relation to the Australian business</i>	122
Step 3	123
<i>In relation to the debt capital of the entity attributable to the Australian business, identify conditions modifying the circumstances under which the Australian business was actually carried on</i>	123
Step 4	124
<i>Determine the amount of debt capital giving rise to debt deductions that the entity's Australian business would reasonably be expected to have throughout the year</i>	124
Step 5	125
<i>Determine the amount of debt capital that commercial lending institutions dealing with the entity at arm's length would reasonably be expected to provide throughout the year</i>	125
Step 6	126
<i>Determine the Arm's Length Debt Amount</i>	126
<b>Detailed contents list</b>	<b>127</b>
<b>Your comments</b>	<b>128</b>

**Your comments**

128. If you wish to comment on this draft Ruling, please send your comments promptly by **21 June 2002** to:

**Contact Officer:** Graeme Clark  
**E-Mail address:** [graeme.clark@ato.gov.au](mailto:graeme.clark@ato.gov.au)  
**Telephone:** (03) 9285 1179  
**Facsimile:** (03) 9285 1410  
**Address:** International Centre of Expertise  
 33<sup>rd</sup> Floor 2 Lonsdale St  
 Melbourne VIC 3000

**Commissioner of Taxation**

15 May 2002

*Previous draft:*

Not previously released in draft form

- ITAA 1997 820-200

- ITAA 1997 820-205

- ITAA 1997 820-210

*Related Rulings:*

TR 2001/11

- ITAA 1997 820-215

- ITAA 1997 820-215(1)

- ITAA 1997 820-215(1)(a)

- ITAA 1997 820-215(1)(b)

*Subject references:*

- arm's length debt amount

- ITAA 1997 820-215(2)

- arm's length debt test

- ITAA 1997 820-215(2)(a)(ii)

- maximum allowable debt

- ITAA 1997 820-215(2)(d)

- non-ADI entities

- ITAA 1997 820-215(3)

- thin capitalisation

- ITAA 1997 820-215(3)(a)

- ITAA 1997 820-215(3)(j)

*Legislative references:*

- ITAA 1936 Div13

- ITAA 1997 820-215(4)

- ITAA 1936 Pt IVA

- ITAA 1997 820-315

- ITAA 1997 820-37

- ITAA 1997 820-410

- ITAA 1997 820-40

- ITAA 1997 820-910

- ITAA 1997 820-85(2)

- ITAA 1997 820-980

- ITAA 1997 820-85(3)

- ITAA 1997 960-100

- ITAA 1997 820-90

- ITAA 1997 974-20(1)

- ITAA 1997 820-95

- ITAA 1997 995-1(1)

- ITAA 1997 820-100

- ITAA 1997 Subdiv 820-G

- ITAA 1997 820-105(1)

- ITAA 1997 Subdiv 820-F

- ITAA 1997 820-105(1)(a)

- ITAA 1997 Subdiv 974B

- ITAA 1997 820-105(1)(b)

- ITAA 1997 Div 820

- ITAA 1997 820-105(2)

- Banking Act 1959

- ITAA 1997 820-105(2)(a)(ii)

- ITAA 1997 820-105(2)(d)

*Case references:*

- ITAA 1997 820-105(3)

- FC of T v. Peabody 94 ATC 4663;

- ITAA 1997 820-105(3)(a)

28 ATR 344

- ITAA 1997 820-105(3)(k)

- Stratton v. Simpson (1970) 125 CLR

- ITAA 1997 820-105(4)

138; [1971] ALR 117

- ITAA 1997 820-105

- ITAA 1997 820-110

- ITAA 1997 820-185(2)

- ITAA 1997 820-185(3)

- ITAA 1997 820-190

- ITAA 1997 820-195



Australian  
Taxation

Official comment

Draft Taxation Ruling

**TR 2002/D4**

Page 36 of 36

---

ATO references:

NO T2002/005502

ISSN: 1039-0731