The Tax Institute

7 February 2025

Mr Stephen Dodshon
Assistant Commissioner
New Measures
Public Groups
Australian Taxation Office

By email: stephen.dodshon@ato.gov.au

Dear Mr Dodshon,

ATO consultation on PCG 2024/D3 and TR 2024/D3

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft Taxation Ruling TR 2024/D3 Income tax: *aspects of the third-party debt test in Subdivision 820-EAB of the Income Tax Assessment Act 1997 (Cth)* (**draft TR**) and PCG 2024/D3: *Restructures and the new thin capitalisation and debt deduction creation rules* (**draft PCG**) *(*collectively, **the draft guidance***)***.**

In the development of this submission, we have closely consulted with our National Large Business and International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The Tax Institute welcomes the provision of guidance on the thin capitalisation rules in a binding form, given the importance of these rules to taxpayers with Australian operations and having regard to the substantial changes recently made to them. Guidance on the third-party debt test is particularly important given that for many taxpayers, the amount of debt deductions allowable under the fixed ratio test will be substantially less than the amount of debt deductions available under the previous safe harbour rules.

However, we consider that the existing guidance can be improved and expanded in a number of areas. Further, given the prevalence of conduit financing arrangements in the infrastructure and property sectors, in particular, we would welcome the publication of guidance on the conduit financing rules as soon as possible.

Our detailed response and recommendations to further improve the draft guidance are contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact our Head of Tax & Legal, Julie Abdalla, at (02) 8223 0058.

Yours faithfully,

Julie Abdalla
Head of Tax & Legal

Tim Sandow
President

APPENDIX A

We have set out below our detailed comments and observations on the draft guidance for your consideration.

TR 2024/D3 Income tax: aspects of the third-party debt test in Subdivision 820-EAB

'Attributable to'

The draft TR contains a brief discussion of the meaning of 'attributable to' in the context of subsection 820-427A(1). However, it primarily focuses on the deeming rule in subsection 820-427A(2), which only applies in circumstances where amounts are paid to an entity that is not an associate entity. In that regard, the draft TR concludes (in Example 1) that amounts paid by Project Trust to Fin Co under the on-swap do not satisfy the deeming rule in subsection 820-427A(2). It does not consider or express a view on whether amounts paid under the on-swap are attributable to the on-loan for the purposes of subsection 820-427A(1) and, therefore, included in Project Trust's third-party earnings limit if the on-loan satisfies the third-party debt conditions as modified by the conduit financing rules.

Applying the analysis in paragraphs 14 to 16 of the draft TR, we consider that amounts paid under the on-swap should be 'attributable to' the on-loan on the basis that:

- the words 'attributable to' in subsection 820-427A(1) reflect a similar nexus enquiry as 'in relation to' as it appeared in subsection 820-40(1) prior to its recent amendment;
- the drafting of section 820-40 prior to its recent amendment clearly envisaged that costs associated with hedging or managing the financial risk in respect of a debt interest were incurred 'in relation to' that debt interest (refer former paragraph 820-40(3)(a)); and
- it is clear in the example that the on-swap is entered into to hedge / manage the financial risk with respect to the on-loan.

The above analysis is inconsistent with the statement in the opening sentence of paragraph 19 of the draft TR that debt deductions in relation to conventional interest rate swaps are not attributable to debt interests outside of the deeming rule in section 820-427A. We are of the view that the statement in the draft TR is incorrect and should be amended. If it were correct, it implies the rules prevent the use of swaps in conduit financing arrangements, which was clearly not intended by the legislation.

Example 26 of the draft PCG considers a restructure under which the terms of an on-loan and on-swap agreement are amended to terminate the on-swap and to build the effect of the on-swap into the terms of the on-loan. The draft PCG is intended to provide comfort to taxpayers in relation to the ATO's allocation of compliance resources to investigate such restructures, but it is implicit from the Example that the ATO considers that the post-restructure facts will satisfy the technical requirements of the third-party debt test. That is, it is implicit that the ATO considers that swap costs which are built into an on-loan arrangement (rather than being incurred under a separate on-swap agreement) are 'attributable to' the loan made under the on-loan agreement. While we agree with that analysis, it is difficult to see how a cost incurred under a single agreement could not be 'attributable to' a debt interest issued under that agreement.

We also consider that analysis supports the above interpretation of 'attributable to' in section 820-427A and confirms that costs can be 'attributable to' a debt interest even where they do not satisfy the deeming rule in subsection 820-427A(2). This is contrary to the statement in paragraph 19 of the draft TR (as swap costs passed on in a conduit financing structure will, by definition, never satisfy the deeming rule in subsection 820-427A(2)). Such an interpretation would also be consistent with the ATO's interpretation of the phrase in other contexts, for example in *Law Companion Ruling LCR 2020/2: Non-concessional MIT income* which states (at [20]):

> '[c]consistent with judicial consideration of the phrase "attributable to" in other contexts, its use … should also be interpreted broadly'.

We therefore recommend that the analysis and conclusion in relation to the final structure should be included in the draft TR.

'Minor or insignificant'

The draft TR construes 'minor or insignificant' assets as covering 'assets of minimal or nominal value' without due consideration of the meaning of 'insignificant'. In doing so, it states expressly that the relative value of the relevant assets, as compared with the market value of a taxpayer's total assets, is not determinative (Example 9). We consider that an expanded, more flexible approach, that takes into account the size and nature of the relevant taxpayer (potentially including a consideration of the relative value of the relevant assets as compared with the taxpayer's total assets) would be more consistent with Parliament's intent and should be adopted by the ATO.

In that regard, and as noted in the draft TR, the Supplementary Explanatory Memorandum to the *Treasury Laws Amendment (Making Multinationals Pay their fair share- Integrity and Transparency) Act 2024* states that the carve-out is intended to prevent the test from being contravened for inadvertent or superficial reasons. The size and nature of a taxpayer's operations will naturally impact the materiality threshold applied by the taxpayer and, therefore, the size and value of assets that may be inadvertently overlooked. The ATO should consider expanding its interpretation of the term to include assets which have no impact on the quantum or terms of the debt interests issued.

'Australian assets'

As outlined in the draft TR, except in the case of limited recourse debt, lenders will have 'recourse' to all assets of the issuer of a debt interest, whether or not security is granted over some, all, or none, of those assets. Accordingly, the third-party debt conditions will only be satisfied in respect of a debt interest which is not limited recourse if:

- the issuer only has Australian assets; or
- the non-Australian assets held by the issuer are minor or insignificant.

In practice, it is likely to be difficult for lenders to accept their recourse being limited to Australian assets where an asset could be made non-Australian (and therefore beyond the reach of lenders) using simple steps. Example 22 in the draft PCG suggests that cash held in a non-Australian bank account (for example) would not be an Australian asset.

Against that background, it is crucial that taxpayers are able to clearly understand when an asset will be Australian or not Australian, and that the test operates in a way that enables the third-party debt test to be applied in real commercial settings. In particular, we consider that additional guidance and a range of examples are required to assist taxpayers in determining the circumstances in which intangible assets, including rights against foreign assets, are Australian assets. To take a simple example, an Australian trust or company that intends to construct and operate a renewable energy generation project in Australia is likely to hold the following assets at various stages of the project lifecycle:

- freehold or leasehold land situated in Australia – this will clearly be an Australian asset;
- physical assets comprising the project (e.g. wind turbines or solar panels and associated connections, wiring and transmission assets) – these will be located in Australia and will also be Australian assets; and
- a series of contractual rights which may have Australian or foreign counterparties, such as:
    - supply agreements – query whether these be Australian assets since they relate to the construction of a project in Australia;
    - insurance contracts – query whether these be Australian assets since they relate to assets situated in Australia; and
    - swap contracts – query whether these be Australian assets since they relate to the financing of an Australian project.

Further, Example 22 in the draft PCG is unhelpful in this regard, as it implies that an account with a non-Australian bank is not an Australian asset. While the facts outlined in the example are quite brief, it appears that the relevant taxpayer, Mining Co:

- is an Australian company;
- has only Australian operations; and
- operates an Australian mine and derives income from selling minerals produced in Australia to Australian and foreign customers.

The draft TR does not contain any analysis that outlines the basis on which the bank account is not an Australian asset, but the account being with a foreign bank seems to be crucial to the conclusion. Weighing against that conclusion is that the bank account is merely a contractual right and the only non-Australian connection is the counterparty. The funds in the account are the proceeds of selling minerals mined in Australia by an Australian company – and the example suggests that, in practice, the proceeds are repatriated to Australia shortly after payment.

Separate to the contractual rights issue, taxpayers will likely need further guidance on the circumstances in which shares in companies will be Australian assets. In that regard, the draft TR currently states that:

- shares in an Australian company that carries on business through a foreign permanent establishment are not Australian assets – even if the company also operates in Australia (Example 13); and
- shares in a non-Australian company that carries on business wholly offshore are not Australian assets (Example 14).

However, the draft TR does not confirm whether shares in companies further upstream are Australian assets. For example, in Example 13, whether shares in Head Co are Australian assets (this would be relevant if Head Co was itself a subsidiary of another entity that issued debt), and in Example 14, whether shares in Sub Co and/or shares in Head Co are Australian assets.

Paragraph 820-427A(3)(d)

The draft TR states in paragraphs 98 to 100 that the obligation to use all, or substantially all, of the proceeds of issuing the debt to fund its commercial activities in connection with Australia is an ongoing requirement, not limited to the relevant income year. This requires tracing of any future use of these proceeds. For example, if proceeds are used to purchase an asset, and that asset is sold, the use of the proceeds of that sale also need to be considered with a requirement to maintain records. This interpretation presents the following significant challenges:

- it appears to go beyond the legislative intent. If the legislation intended that it applied in this way, it would expressly say so. There is no indication in the words of the legislation itself that one needs to consider the subsequent use of proceeds in circumstances where there is a subsequent disposal of assets funded by the debt. Any concern in this regard should be able to be dealt with via the anti-avoidance provisions contained in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**) (e.g. if a taxpayer purchases an asset from the proceeds, immediately sells the asset, and then uses the proceeds in a way that does not fund its commercial activities in connection with Australia for the purpose of satisfying the third-party debt test);
- this interpretation results in unintended outcomes, particularly with respect to prior income years. For example, if a taxpayer uses the proceeds to fund its commercial activities in connection with Australia by purchasing assets in Year 1, and claims interest deductions from Years 1 to 5, and in Year 6 sells an asset and does not use the proceeds of that sale to fund its commercial activities in connection with Australia, it would be unreasonable for the taxpayer to then be required to amend its income tax returns for the prior income years (some of which may be out of time) to deny deductions for the interest on the third-party debt; and
- such an interpretation imposes an excessive burden on taxpayers to indefinitely trace these proceeds, particularly in circumstances where the volume of assets acquired from such proceeds is significant. It would be impractical for businesses to engage in continual tracing over an indefinite period.

We are of the view that if such an interpretation is to be adopted, there should be:

- clarity in the draft TR that an invalidating use for a debt interest in an income year will not impact the ability of that debt interest to satisfy the requirement in paragraph 820-427A(3)(d) in prior income years (particularly as the test is applied to 'the relevant income year' at that time, not with reference to a future time or use); and
- an administrative concession (perhaps in the draft PCG) to disregard the use of proceeds for debt on issue prior to the application of the new rules to taxpayers, noting that no other area of tax law requires continuous tracing of such use.

Similarly, it is unclear how debt used to repay other debt is to be treated. In our view, it would be unreasonable to deny deductions on a debt issued today, that was used to repay a debt used historically in a way that does not fund commercial activities in connection with Australia. A debt refinance should be considered to be to fund a taxpayer's commercial activities in connection with Australia. Again, the anti-avoidance provisions contained in Part IVA of the ITAA 1936 should be able to deal with any specific concerns that the refinance of debt was done with the sole or dominant purpose of refreshing third-party debt deductions on a debt that had disallowances.

'All, or substantially all'

In relation to the requirement that 'all, or substantially all' of the proceeds to fund its commercial activities in connection with Australia, the ATO view outlined in paragraphs 102 and 103 of the draft TR appears to indicate that the ATO would accommodate 'a minimal or nominal portion' of the proceeds being used other than to fund the entity's commercial activities in connection with Australia, such as 'customary' borrowing fees and finance charges met out of the proceeds of the debt. In our view, this interpretation is too narrow for the following reasons:

- it implies that borrowing fees and charges are not a use of proceeds to fund commercial activities, disregarding that the incurrence of such amounts is necessary to secure the funds to apply to the commercial activities in connection with Australia and therefore should be considered to be for that same use;
- the draft TR suggests that the use of funds to fund working capital or operational expenses is not considered to be the funding of commercial activities in connection with Australia. This has implications, for example, for third-party revolving facilities used to fund these expenses. This approach ignores that such working capital and payment of expenses is fundamental to the carrying on of commercial activities and therefore forms part of the commercial activities; and
- it is problematic for scenarios where loans are issued with significant establishment costs in order to reduce interest expense that may be capitalised in the loan itself. The implication of the view outlined in the draft TR is that such arrangements would result in the debt deductions being denied.

We consider that it would be helpful for the taxpayers if the ATO would consider a broader, more practical interpretation, taking into account the above implications of the current view.

Guarantees and credit support rights

We would welcome additional guidance in relation to the treatment of guarantee and credit support rights. In that regard, the draft TR confirms that the rules do not 'look through' rights against other entities to identify the assets to which lenders have recourse (paragraph 42). However, most of the analysis in the draft TR on these aspects concerns the 'permitted' forms of credit support which do not result in failure of the third-party debt conditions.

At a more general level, additional detail would be welcomed in relation to the treatment of:

- performance guarantees (as compared to financial guarantees);
- guarantees given to lenders that are not rights/assets held by the borrower (i.e. guarantees under which the guarantor will be a member of the obligor group); and

- guarantees in favour of the borrower which support obligations owed to the borrower (*cf* supporting obligations of the borrower), that is, where there is an asset held by the borrower.

In relation to guarantees in favour of the borrower such as the guarantee in Example 6, it would be helpful for the ATO to further explain the basis on which it considers that such guarantees are considered to be 'a guarantee, security or other form of credit support' for the purposes of subsection 820-427A(5). In that regard, it is submitted that subsection 820-427A(5) is concerned with guarantees etc. which support the credit of the borrower – the guarantee in Example 6 is supporting the credit of Sub Co in relation to Sub Co's obligations under the lease; it is not supporting the credit of Asset Trust. Accordingly, it is submitted that the application of the third-party debt test for Asset Trust should be the same regardless of whether Head Co (the guarantor) is an associate entity of Asset Trust, contrary to the comments in paragraph 59.

If that approach were incorrect, the thin capitalisation outcomes for Asset Trust would be substantially different were it to lease the property to Head Co as compared to leasing the property to Sub Co whose obligations are guaranteed by Head Co, although the economic and commercial outcomes would be the same.

This issue is particularly relevant given that a number of renewable energy projects (for example) involve entering into long term offtake agreements in circumstances where:

- the off-taker may be a special purpose vehicle (**SPV**) or entity of limited substance;
- the SPV's obligations are guaranteed by the head company of the off-taker; and
- the head company of the off-taker may be an associate entity of the project owner/borrower, noting that a 20% ownership threshold applies for the purposes of identifying associate entities when applying subparagraph 820-427A(5)(a)(ii).

Example 19 of the draft TR – credit support rights relating to the development of an asset

Given the prevalence of equity support arrangements in project-finance structures that will rely on the third-party debt test, either in relation to cost-overrun support or general equity support where debt finance is used to fund initial costs before equity is drawn, the inclusion of Example 19 is welcomed. However, it would be helpful if additional issues could be considered and confirmed in the Example, including the following:

- How do taxpayers confirm that credit support is related to the development of relevant assets? Is it sufficient, for example, that the credit support automatically terminates when (or shortly after) a project achieves commercial operation?
- Credit support rights such as those considered often need to be supported by equity support instruments, in the form of guarantees from an entity of substance or a bank guarantee. It would be helpful for the draft TR to confirm that the exception in subparagraphs 820-427A(5)(a)(iii) and (iv) would not cease to apply as a result of the credit support being underpinned by:
  - a parent company guarantee issued by an entity that is either not a foreign entity, or not an associate entity of the borrower; or
  - a bank guarantee, provided the issuing bank is either not a foreign entity, or not an associate entity of the borrower.

Commercial activities in connection with Australia

Paragraph 107 and Example 16 indicate that the ATO's view that 'commercial activities in connection with Australia' is that it is designed to cover debt used to fund investment in the Australian operations of trade or business capable of generating a profit. Examples of activities that do not meet that description include the payment of distributions, capital management activities, or the indirect purchase of foreign assets through an Australian entity. In our view, this approach is too narrow. Further, at least insofar as it relates to debt to fund returns of capital, these comments are inconsistent with the refinancing principle in *Federal Commissioner of Taxation v Joan Dorothy Roberts; Commissioner of Taxation v Valentine Roy Smith (1992) 37 FCR 246* as described in Taxation Ruling TR 2005/12: *Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries*.

Broadly, where the borrowed funds replace funds previously provided by the beneficiaries of the trust or shareholders in a company and used by the trust or company in income producing activities, interest on the borrowing is deductible under ordinary principles on the basis that the borrowing has a sufficient connection with the income producing activity. For the same reasons, the borrowed funds should be considered as used to fund commercial activities in connection with Australia.

Practically, it is extremely difficult to exclude the proceeds of debt from being used to fund the payment of distributions. For example, if the taxpayer has $1 million of profits for an income year and traces cash from operating the business to pay a $1 million distribution, there would be no impact on the deductibility of the taxpayer's third-party debt. If, however, the same taxpayer only has $800,000 of cash from its business operations in the bank, and its bank account is co-mingled with proceeds of a third-party debt issuance, and the taxpayer pays a $1 million distribution from those co-mingled funds, the entire interest on the taxpayer's third-party debt would be non-deductible under the ATO's interpretation. This represents an unnecessary burden on a taxpayer's ability to make distributions and impedes a taxpayer's ability to reinvest their profits while still paying distributions of profit, as doing so would put at risk the deductibility of interest on third-party debt.

A narrow view of 'in connection with Australia' is also problematic. For example, where the deposit of proceeds from a debt issuance are briefly held in a foreign account (e.g. a USPP debt raise clearing account), it would not be reasonable to consider such a deposit to cause the 'in connection with Australia' requirement to be failed, as it too narrowly ignores the fact that the proceeds are ultimately 'to fund its commercial activities in Australia' (i.e. the word 'to' implies purpose).

It is also unclear whether the ATO views that a failure to meet this requirement in one year taints the debt for its life (i.e. disallowing deductions in any income year). We are of the view that this should be clarified, including in respect of prior income years.

Other issues

In addition to the above, there are a number of aspects of the third-party debt test (other than the conduit financing rules) that are not discussed in the guidance, and which we consider should be addressed. For example, regarding the tax consolidation interaction with respect to the application of the third-party debt test, the draft TR should clarify:

- how the rules apply in relation to debt borrowed by members of a tax consolidated group, including the implications of the single entity rule in identifying the entity that issued the debt interest and which assets are held by that entity, and confirming that on-lending between members of a tax consolidated group is disregarded for the purposes of subsection 820-427A(4);
- that where the borrower and entities that would, absent tax consolidation, be considered to be members of the 'obligor group' (e.g. guarantors) are all members of the same tax consolidated group, effectively there is no 'obligor group' for that particular taxpayer (paragraph 5);
- in the above circumstances, 'recourse for payment of the debt' should be to the particular assets of the tax consolidated group to which the holder has recourse, having regard to any security agreements, mortgages and guarantees involving members of the tax consolidated group (paragraphs 36-39);
- relevant to the general prohibition on recourse to Australian assets that are rights under or in relation to a guarantee, security or other form of credit support (except for recourse from a non-associate entity), recourse from entities that are members of the same tax consolidated group (e.g. rights under or in relation to a guarantee provided by a member of the same tax consolidated group) should not cause the prohibition to apply; and
- how costs incurred under foreign exchange swaps are treated under the third-party debt test.

PCG 2024/D3: Restructures and the new thin capitalisation and debt deduction creation rules - ATO compliance approach, updated to include new Schedules 3 and 4

Further examples

Taxpayers would be assisted by the inclusion of further examples that the Commissioner would consider to be low or medium risk. For example, refinancing non-compliant debt with compliant debt should be considered low risk as it merely results in debt capacity that would have been the case had the original debt been borrowed at a time when the new thin cap rules existed. Further examples covering the conduit financier should also be included.

Example 22 – Disposal of foreign assets

Example 22 contemplates an offshore bank account as not constituting an Australian asset. It would be helpful to clarify that this interpretation is intended to apply to bank accounts maintained in a foreign jurisdiction, and not to funds maintained in a foreign currency denominated bank account in Australia.

Paragraph 245 – minor or insignificant assets

The Commissioner's proposed compliance approach in paragraph 244 includes a requirement that the market value of the assets is less than 1% of all assets to which a lender has recourse and the market value of each asset does not exceed $1m. We consider that the percentage threshold alone is appropriate as it means that large businesses (who are more likely to have single assets exceeding $1m while still being well below the threshold) are treated differently to small businesses that practically would solely rely on the 1% threshold.

Example 29 – High-risk amending conduit financing interest rates

We understand the intention of the draft PCG is to give taxpayers comfort in relation to the ATO's compliance approach in respect of restructures undertaken to comply with certain aspects of the amended thin capitalisation rules. Against that background, the expectation is that the post-restructure structures included in the Examples satisfy the technical requirements of the rules, with the compliance issues to which resources may or may not be allocated being the application of specific or general anti-avoidance rules. However, Example 29 creates some uncertainty as the resulting structure does not seem to satisfy the conduit financing which, relevantly, require:

- identification of an ultimate debt interest (in the Example, each loan from Invest Bank to Fin Co should be a separate debt interest);
- the on-loan to be financed only with proceeds from the ultimate debt interest; and
- the terms of the on-loan relating to pricing to be the same as the terms of the ultimate debt interest.

Under the example, all on-loans adopt the pricing of the most expensive ultimate debt interest, but it is not possible for all on-loans to be financed only with proceeds from the most expensive ultimate debt interest. Accordingly, the resulting structure in Example 29 would not seem to satisfy the applicable technical requirements. Therefore, we consider that it would be helpful for taxpayers if the ATO could amend Example 29 in such a way that it satisfies the technical requirements of the rules.