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14 February 2025

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New Measures, Public Groups
Australian Taxation Office

By email: Stephen.Dodshon@ato.gov.au

Dear Assistant Commissioner

Submission on the application of Thin Capitalisation Third-Party Debt Test and Schedule 3 of PCG 2024/D3

The Property Council of Australia (the Property Council) welcomes the opportunity to respond to the Australian Taxation Office's (ATO) consultation on the latest guidance and rulings for Thin Capitalisation and the Third-Party Debt Test.

The Property Council is the peak body for owners and investors in Australia's $670 billion property industry. We represent owners, fund managers, superannuation trusts, developers, and investors across all four quadrants of property investments: debt, equity, public and private.

The introduction of Thin Capitalisation rules without clear guidance has created concern for our members and Australia's ability to attract and keep global capital, impacting our competitiveness of as a safe and stable destination for investment in a competitive landscape. Current challenges remain across the economy to build investment in the property industry.

We welcome consultation with the ATO to assist in delivering useful, consistent and globally comparable information to help our sector continue to develop and grow. Our members have raised several concerns with the current drafting and the implementation of the guidance in its current form and we outline those in this submission.

The Property Council and our members have been engaged and eager to assist the ATO and Treasury in drafting and delivery of Thin Capitalisation rules, we continue to offer our assistance as these rules continue to develop into rules that work for industry.

With an election only weeks away, industry is concerned that the lack of progress in guidance from the ATO on substantial issues impacting distributions, tax elections and future deals, the caretaker period preventing the ATO from making determinations and issuing additional guidance will hamstring industry at a time they can least afford to be hamstrung. With around 20 weeks remaining in the financial year this is the time for decisive action from the ATO to give confidence to businesses that they can make decisions without negative ramifications.

In response to the consultation paper and draft rulings, the Property Council has outlined several recommendations for the ATO to consider or investigate further.

1. "Australian assets' and 'commercial activities in connection with Australia'

RECOMMENDATION 1

1.1. 'Commercial activities in connection with Australia' should be determined by excluding:

(i) any business carried on at or through its overseas permanent establishments; and

(ii) the holding of any associate entity debt, controlled foreign entity debt or controlled foreign entity equity

1.2. The term 'Australian assets' should encompass assets that are attributable to commercial activities in connection with Australia, other than any business carried on at or through its overseas permanent establishments or the holding of any controlled foreign entity debt or controlled foreign entity equity ("excluded foreign activities")

An asset would be attributable to commercial activities in connection with Australia, other than "excluded foreign activities", where the asset is employed (including as part of a business) in deriving assessable income or non-assessable non-exempt (NANE) income, other than assessable income or NANE attributable to "excluded foreign activities".

Explanatory Memorandum – TPDT 'is designed to be narrow'

The ATO's restrictive views in respect of the term 'Australian assets' and the expression 'commercial activities in connection with Australia' are said to be supported by the explanatory memorandum (**EM**) comment that 'the TPDT is designed to be narrow, to accommodate only genuine commercial arrangements relating only to Australian business operations', however this comment in the EM does not relate specifically to the term 'Australian assets' or the expression 'commercial activities in connection with Australia', but rather is included in the 'overview' section to contrast the TPDT with the previous arm's length debt test (**ALDT**):

> *2.90 The third-party debt test operates effectively as a credit assessment test, in which an independent commercial lender determines the level and structure of debt finance it is prepared to provide an entity.*

2.91 The test is intended to be a simpler and more streamlined test to apply and administer than the former arm's length debt test, which operates based on valuation metrics and the 'hypothesised entity comparison'.

2.92 The third-party debt test is designed to be narrow, to accommodate only genuine commercial arrangements relating only to Australian business operations. This is a considered design approach and is not intended to accommodate all debt financing arrangements that may be accepted as current practice within industry.

2.93 In this regard, the third-party debt test balances the tax integrity policy intent and the need to ensure genuine commercial arrangements are not unduly impeded.

This context is important. The TPDT is already clearly narrower than the ALDT because there is no scope to undertake a hypothesised entity comparison, but rather the TPD conditions will only be met where the actual activities meet the requirements. The TPDT is also only available for third party debt, whereas the ALDT could be applied for related party debt. That is the context in which 'the TPDT is designed to be narrow', and these comments in the EM in no way support the imposition of restrictive interpretations generally when applying the TPDT.

Importantly, pursuant to the EM, the objective of the TPDT 'as a credit assessment test, in which an independent commercial lender determines the level and structure of debt finance it is prepared to provide' 'relating only to Australian business operations' is the same as the objective of the ALDT as set out in the explanatory memorandum to *New Business Tax System (Thin Capitalisation) Bill 2001* (**2001 EM**)*:*

10.3 The point of the [arm's length debt] *test is to examine the circumstances of the taxpayer to determine whether the Australian operations, when viewed independently from the foreign operations could, on an arm's length basis, have been undertaken with the actual amount of debt or equity used by the taxpayer.*

…

10.10 The focus of the arm's length debt analysis is on the Australian operations of the investing entity. The analysis looks to the assets of those operations as the source of cash flows to meet the debt repayments and the other liabilities of the operations.

…

10.14 The objective of the analysis will be to establish the notional amount of debt that the entity would reasonably be expected to have held throughout the period, and that independent commercial lenders would have provided on arm's length terms and conditions.

While the TPDT is narrower, as it only applies to third party debt and imposes conditions in relation to Australian operations (rather than requiring factual assumptions), the outcomes under the TPDT and ALDT would generally be expected to be aligned in a situation where the TPD conditions

are met, on the basis that the required factual assumptions in applying the ALDT would be the same as the actual conditions.

A restrictive interpretation of the term 'Australian assets' and the expression 'commercial activities in connection with Australia' is therefore not supported by the 'overview' comments in the EM referred to in the Draft Ruling. Rather, the EM supports a view that the underlying policy of the TPDT is the same as the ALDT, albeit that the TPDT 'is intended to be a simpler and more streamlined test to apply and administer than the former ALDT' as it does not operate 'based on valuation metrics and the 'hypothesised entity comparison' and is 'narrower' in that it only applies to third party debt and does not require (or permit) factual assumptions to determine the hypothetical entity and a comparison to third party arrangements.

Given the obvious linkages between the policy objective and terminology adopted in the TPDT and the former ALDT, it is appropriate to consider the operation of the ALDT and existing ALDT guidance to assist with the interpretation of the TPD conditions, while properly taking into account the way in which the TPDT is designed to be narrower. This is recognised by the ATO in the context of the expression 'guarantee, security or credit support' which is said to carry the same meaning as in former paragraphs 820-105(2)(e) and 820-215(2)(e) such that ATO guidance on those former provisions is relevant (footnote 49 of the Draft Ruling).

Interpretation of 'Australian assets' and 'commercial activities in connection with Australia'

Rather than seeking to restrict the scope of the term 'Australian assets' by reference to the degree of Australian or foreign connection for each asset, including whether a foreign entity is a party to a contract, the EM focusses on excluding assets attributable to offshore operations (emphasis added):

> *2.98 'Australian assets' is intended to capture assets that are substantially connected to Australia. The following assets are not intended to be Australian assets:*
>
> *• Assets that are **attributable to the entity's overseas permanent establishments**.*
>
> *• Assets that are otherwise **attributable to the offshore commercial activities of an entity**.*

The term 'Australian assets' therefore clearly needs to be considered in conjunction with the expression 'commercial activities in connection with Australia', including the exclusions for any overseas permanent establishment, controlled foreign entity debt or equity[1].

The exact expression 'commercial activities in connection with Australia' was used in former paragraph 820-105(2)(a). Considering guidance in relation to former paragraph 820-105(2)(a) is

[1] The exclusion for 'associate entity debt' seems to have been carried over into the TPDT based on the way in which the former thin capitalisation rules operated to require 'bottom up' testing using a balance sheet approach. As the exclusion for associate entity debt is not referable to foreign operations, it is not considered relevant to the term 'Australian assets'.

plainly a better approach to interpreting the expression in the context, given that the objective of the TPDT is the same as the ALDT, albeit narrower in design as discussed above.

From the 2001 EM:

> *10.11 The arm's length debt amount is determined by conducting an analysis of certain facts and circumstances. The analysis results in a notional amount that represents what would reasonably be expected to have been the entity's average interest-bearing debt amount during the period, having regard to certain factual assumptions and relevant factors.* ***Those assumptions and factors establish a scenario that would have existed if the entity's Australian operations were independent from any other operations that the entity*** *or its associates had during the period, and had been financed by an acceptable mix of equity and debt funding.*

The relevant assumptions to identify the Australian operations under the ALDT pursuant to former subsection 820-105(2) were:

> *(a) the entity' s commercial activities in connection with Australia (**the Australian business**) during that year do not include:*
>
> > *(i) any *business carried on by the entity at or through its *overseas permanent establishments; and*
> >
> > *(ii) the holding of any *associate entity debt, *controlled foreign entity debt or *controlled foreign entity equity; and*
>
> *...*
>
> *(c) the nature of the entity's assets and liabilities (to the extent that they are attributable to the Australian business) had been as they were during that year;*
>
> *...*
>
> *(f) the entity' s only activities during that year were the Australian business;*
>
> *(g) the entity' s only assets and liabilities during that year were those referred to in paragraph (c) of this subsection.*

In seeking to achieve the same policy objectives as the ALDT, while consistent with the narrow design of the TPDT 'to accommodate only genuine commercial arrangements relating only to Australian business operations', the term 'Australian assets' and the expression 'commercial activities in connection with Australia' could be seen to effectively adopt the above assumptions as conditions.

Accordingly, consistent with the former subsection 820-105(2)(a) and (f), the 'commercial activities in connection with Australia' should be determined by excluding:

> (i) any *business carried on by the entity at or through its *overseas permanent establishments; and

(ii) the holding by the entity of any *associate entity debt, *controlled foreign entity debt or *controlled foreign entity equity;

This interpretation has the effect of creating a condition (consistent with the assumption that applied under the ADLT) that all, or substantially all, of the proceeds of issuing the debt interest are used to fund Australian operations, which achieves the policy objectives of the TPDT.

Focusing on excluded activities that are clearly defined provides clarity on the requirement that all, or substantially all, of the proceeds are used only to fund commercial activities in connection with Australia. It avoids creation of an imprecise dichotomy between 'Australian operations of trade or business capable of generating profit' and 'capital management activities' (concepts and terms which are not to be found in the legislation or any of the guidance), and the consequent requirements for ongoing tracing of the use of funds within the Australian business, which have no basis in policy, as discussed further below.

Similarly, consistent with the former subsection 820-105(2)(c) and (g), the term 'Australian assets' would encompass assets that are attributable to an entity's commercial activities in connection with Australia excluding any business carried on at or through its overseas permanent establishments and the holding of any controlled foreign entity debt or controlled foreign entity equity (**excluded foreign activities**) [2].

This interpretation has the effect of creating a condition (consistent with the assumption that applied under the ADLT) that the lender only has recourse to assets that are attributable to the Australian business of the borrower or another Australian entity in the tax obligor group, which achieves the policy objectives of the TPDT.

The concept of an asset being attributable to an entity's commercial activities in connection with Australia focuses on the way in which the asset is employed, rather than vague concepts involving the inherent connection that an asset has with a particular jurisdiction, which is better aligned with the policy and avoids the extensive practical issues, anomalies and uncertainties associated with the draft ATO view, as discussed below.

In this regard, an asset would be attributable to an entity's commercial activities in connection with Australia, other than excluded foreign activities, where the asset is employed by the Australian entity (including as part of a business) in deriving assessable income or non-assessable non-exempt (**NANE**) income, other than assessable income or NANE income attributable to excluded foreign activities.

On this basis, assets that directly or indirectly generate assessable income or NANE income attributable to excluded foreign activities would not be 'Australian assets'. For example, the following would not be Australian assets:

- assets attributable to a foreign permanent establishment

[2] As noted above, the exclusion for associate entity debt does not relate to foreign operations and is therefore not considered relevant to the interpretation of the term 'Australian assets'.

- shares in an Australian company that carries on business through a foreign permanent establishment (i.e. Example 13 of the Draft Ruling)
- shares in a controlled foreign company (i.e. Example 14 of the Draft Ruling)
- shares in an Australian company that holds shares in a controlled foreign company (i.e. Example 15 of the Draft Ruling)
- controlled foreign entity equity
- controlled foreign entity debt

Applying concepts of assessable income and NANE income, and the exclusions relating to foreign operations set out in paragraph 820-427A(3)(d) provides a clear and appropriate delineation between Australian assets and non-Australian assets, ensures outcomes aligned with Examples 13, 14 and 15 of the Draft Ruling and is consistent with the policy of the TPDT.

Draft ATO interpretation of 'Australian assets'

The interpretation of the term 'Australian assets' and the comments set out in the Draft Ruling, at a minimum, create significant uncertainty, but more fundamentally are not supported by the context in which the term appears in the legislation or the underlying policy of the TPDT. The views in the Draft Ruling will inevitably result in a range of 'genuine commercial arrangements' failing the TPD conditions in circumstances where such an outcome is not consistent with policy, further enforcing the inappropriateness of the interpretation.

The ATO note that the term 'Australian assets' is not defined and therefore takes on its ordinary meaning in the context it appears. While correct as a principle of interpretation, the ATO view of the context is clearly misaligned with the policy intention, which can be gleaned from the EM and by reference to the ALDT and related guidance material, as discussed above.

Moreover, the interpretation of the term 'Australian assets' in the Draft Ruling should not be preferred as is it unclear, creates significant new uncertainties and will result in outcomes that are both inequitable and contrary to policy.

The following principles can be drawn from the Draft Ruling in relation to whether an asset is an 'Australian asset' (emphasis added):

- whether an asset is an 'Australian asset' depends on the ***facts and circumstances***, including the ***nature of the asset*** involved, and its ***connection or relationship to Australia***.
- Australian real property will ordinarily qualify as an 'Australian asset'.
- Other assets ***exclusively connected*** to Australia and that lack ties to other jurisdictions will generally be 'Australian assets'.
- Where an asset has only a ***tenuous or remote connection*** to another jurisdiction, it may still qualify as an 'Australian asset' provided it has a ***substantial connection*** to Australia.
- Assets that are rights against foreign-resident entities (for example, credit support rights provided to an Australian entity by a foreign entity) should be carefully considered to determine whether they are 'Australian assets'.
- The fact that an asset generates Australian assessable income may weigh in favour of the asset being an Australian asset.

- The fact that an asset does not generate assessable income does not preclude the asset from being an Australian asset.

Example 22 of the Draft PCG also implies that a foreign bank account of an Australian entity is not an Australian asset, without analysis.

Based on the principles set out in the Draft Ruling, it is difficult to see how shares in an Australian company are not Australian assets based on the connection of the asset with Australia, casting significant doubt on the correctness of Example 13 of the Draft Ruling (relating to shares in an Australian company that carries on business through a foreign permanent establishment) and Example 15 of the Draft Ruling (relating to shares in an Australian company that holds shares in a controlled foreign company). It is well established that the location of the shares in a company is where the share register is maintained, for example per Menzies J in the Full Court High Court decision in Esquire Nominees Limited as Trustee of Manolas Trust v. Federal Commissioner of Taxation (1973) 129 CLR 177:

> *It seems to me, however, that in considering the source of a dividend the proper enquiry is not to ascertain where the production of wealth, to which it can ultimately be traced through other companies, took place. This would be too large an enquiry.* ***Nor, at the other extreme, would I attribute the source of a dividend upon a share to the place where the share happens to be located, i.e. the place in which the register is kept upon which the share appears. To do so would be artificial.*** *(See Nathan v. F.C. of T. (1918) 25 C.L.R. 183 at p. 196). To determine the source of the dividend, it is, in my opinion, necessary to examine the situation of the company which pays it out of its profits, rather than by merely looking at the share register.*

In the context of an inquiry to ascertain whether a shareholding in a company pertains to the Australian operations of an entity, making an assessment based on the location of the shares held by the entity in the company is equally artificial. A test that considers whether the shares generate assessable income or NANE income attributable to excluded foreign activities is consistent with the objectives of the TPDT, provides more clarity in its application and better supports the conclusions in Examples 13 and 15 of the Draft Ruling in relation to shares in an Australian company that invests in excluded foreign activities (i.e. a foreign permanent establishment or shares in a controlled foreign company).

More generally, the Draft Ruling fails to provide guidance regarding the range of concepts and factors outlined, which makes it practically difficult to conclude on whether an asset is an 'Australian asset', for example:

- How is the nature of the asset relevant? Will a tangible asset physically located in Australia be an Australian asset? Will a tangible asset physically located outside Australia not be an Australian asset? What about goods that are owned by the entity that are in transit (to a customer or from a supplier) and consequently situated outside of Australia for some period of time during an income year?
- How are intangible assets assessed, and is the nature of the intangible asset relevant in this assessment? If so, how is the nature of the intangible asset relevant, for example are different factors relevant to assessing shares as compared to, say, a bank account? In relation to intangible assets comprising contractual rights, does the nature of the contract make a difference (e.g. software

licence, sale of goods or services, hotel management agreement, loans, swaps, or other financial arrangements)? If so, what factors are relevant in the context of each type of contract?

- In what situations will real property in Australia not qualify as an Australian asset?
- What are relevant 'connections' to Australia and how is the degree of connection to be assessed (e.g. exclusive, substantial or tenuous / remote)?
- When would an asset that generates Australian assessable income not be an Australian asset, and why?
- What needs to be 'carefully considered' in the context of rights against foreign resident entities? Does it make a difference if the foreign resident is a related party, and why?

In conjunction with the ATO's restrictive view of 'minor or insignificant', the position based on the Draft Ruling creates major uncertainty as to whether the TPD conditions can be met by an entity in a range of common scenarios, in particular where the entity holds assets being rights under contracts (sales, purchases, insurance, loans, swaps, services, licences) with non-residents (whether third party or related party) , including where these arrangements generate assessable income and are entered into as part of the entity's Australian business operations.

Where any asset (other than an asset of 'minimal or nominal value') is not an 'Australian asset', the TPD conditions will not be able to be satisfied for the income year. Where a lender has recourse to all the assets of the borrower or a tax obligor group member, any requirement to test (based on a range of uncertain criteria) each asset that is acquired or held during the income year (including contractual rights) is extremely onerous. This type of analysis cannot be consistent with a test that the EM describes as being 'intended to be a simpler and more streamlined test to apply and administer than the former arm's length debt test'.

Importantly, to the extent that 'rights against foreign resident entities' refers to credit support rights, there is already a general prohibition in the TPDT for credit support rights, and the exclusions generally do not apply to credit support rights provided by a foreign entity that is a 20%+ associate entity (other than where the specific development exception applies and the foreign entity is not a 50%+ associate entity).

It is also worth noting that in the context of credit support rights provided by a foreign entity, the legislation assumes that these <u>are</u> Australian assets, otherwise there would be no need for the further prohibition on credit support rights provided by a foreign entity that is a 50%+ associate entity. In other words, this interpretation would appear to completely undermine, for example, the purpose of the development asset concession.

Example 22 of the draft PCG involves an Australian company closing a foreign bank account into which its third-party customers make payments, and 'restructuring' to require third party customers to make payments directly into an Australian bank account. This example clearly illustrates how the draft ATO view is unsupported by policy, while forcing entities to undertake non-commercial behaviour. The sales proceeds of the Australian company are Australian assets, being clearly attributable to commercial activities in connection with Australia generating assessable income - there being no suggestion in the example that the Australian company carries

on any foreign operations. The location of the bank account is, of itself, completely irrelevant to the objectives of the TPDT.

To illustrate this point, if the Australian company carried on business through an overseas PE, but sales proceeds attributable to the PE were paid by customers into an Australian bank account, the draft ATO view would suggest that these amounts are Australian assets (due to the location of the bank account), whereas these amounts are clearly attributable to foreign operations and an excluded foreign activity. Recourse to a bank account attributable to a foreign permanent establishment of an Australian company should result in the TPD conditions being failed, regardless of where the bank account is located.

A third-party lender would not be willing to provide a larger loan just because the sales proceeds are initially paid into an offshore bank account before being transferred to Australia, and would not be willing to lend less where proceeds are paid directly to Australia. On the contrary, an Australian third-party lender may theoretically be willing to lend more in a situation where customers make payments directly to an Australian account where this makes it easier to enforce its security.

Draft ATO interpretation of 'commercial activities in connection with Australia'

The ATO again note that the expression 'commercial activities in connection with Australia' is not defined and therefore takes on its ordinary meaning in the context it appears, but then draws from dictionary definitions of the words 'commercial', 'commerce' and 'activities' to devise a meaning completely devoid from the context. The appropriate context, as evidenced by the EM, is that the TPDT has the same policy objective as the ALDT, but is narrower by design because it replaces factual assumptions with conditions and only applies to third party debt.

The policy objective of the TPDT and the EM comments regarding the 'narrow' design of the TPDT simply do not support the creation of the new positive requirements and restrictions per the Draft Ruling, i.e.:

- A requirement that all the proceeds are used to fund investments in the Australian operations of trade or business capable of generating profit.
- Prohibition on any proceeds being used to fund:
    - the payment of distributions
    - capital management activities (not further defined – but includes borrowing fees and establishment fees)
    - indirect purchase of foreign assets through an Australian entity.

The draft ATO view introduces a range of terms and concepts (e.g. 'Australian operations of trade or business capable of generating profit' as contrast with 'capital management activities') not to be found in the legislation, the EM or any contextual material referred to in the Draft Ruling. Moreover, as discussed above, the additional requirements and restrictions sought to be inferred through the ATO's draft interpretation are not necessary in order for the legislation to achieve the stated policy objectives, seem to have been contemplated to overcome a perceived mischief that

does not exist and have no basis in any of the guidance in relation to the former ALDT, strongly pointing against the correctness of the draft ATO view.

In particular, the requirement that the proceeds fund investments 'capable of generating a profit' is inconsistent with other elements of the thin capitalisation rules – to take an example, an entity that borrows third party debt and on-lends that debt to a related entity is required (under the conduit financing provisions) to on-lend that amount on the 'same terms' with respect to costs, and thereby will be prohibited from investing the funds in a manner that is 'capable of generating a profit' without breaching the conduit financing requirements. In other words, the ATO's draft interpretation means that the (modified) third-party debt conditions can never be satisfied where there is a conduit financer involved, leaving the conduit financing rules completely inoperative, again strongly suggesting the ATO's draft interpretation should not be preferred.

Reference could also be made to relevant judicial guidance in relation to the expressional "commercial transaction", for example Gordon J's summary of the concept of a commercial transaction in *Visy Industries USA Pty Ltd v FC of T [2011] FCA 1065:*

> *80. The concept of a "commercial transaction" stands in contradistinction to a private, recreational or other non-business activity:*
> *Federal Commissioner of Taxation v Haass 99 ATC 4814(1999) 91 FCR 132 at [16]-[18] and*
> *Western Gold Mines NL v Commissioner of Taxation (WA) (1938) 59 CLR 729; cf*
> *Paramedical Services Pty Ltd v Ambulance Service of New South Wales (2005) 217 ALR 502 at [86];*
> *Argy v Blunts & Lane Cove Real Estate Pty Ltd (1990) 26 FCR 112 at 127-130 and*
> *Lubidineuse v Bevanere Pty Ltd (1984) 3 FCR 1 at 11-12.*
>
> *81. So, for example, where a transaction occurs in the ordinary course of, or is an incident of, carrying on a business, it will generally be stamped with the character of a commercial transaction: Myer Emporium at 209.*

Capital management activities are clearly an incident of carrying on a business, and therefore similarly stamped with the character of 'commercial' activities. 'Commercial activities' should therefore extend to all of an entity's investing activities as well as its interactions with security holders, including the processes associated with making distributions and capital management. The payment of a dividend or distribution is a basic regularly occurring business-as-usual event for taxpayers, and are 'commercial activities'. Similarly, financing costs are part of an entity's 'commercial activities', including interest and borrowing costs.

A restrictive view of 'commercial activities', in conjunction with the ATO view that only 'minimal or nominal' use in other activities is permissible, will impact on the ability to satisfy the TPD conditions in a range of common situations, for example:

- the use of proceeds to refinance existing loans – although in this case there is also an argument that the use of the proceeds of the new loan should be taken to be the same as the use of the proceeds of the existing loans (although this is not directly discussed in the Draft Ruling). This

creates similar issues to those highlighted in respect of the debt deduction creation rule (**DDCR**) when seeking to evidence the use of historical loans, noting that there was no requirement to maintain such documentation at the time the loans were originally issued.

- as the ATO seem to take the draft view that funding borrowing fees and establishment fees are not commercial activities, the use of proceeds to fund borrowing costs or establishment fees that are not 'minimal or nominal' would result in a failure of the condition. It is common for accrued interest under an existing construction loan to be funded by the proceeds of a refinanced loan, resulting in a failure of the TPD conditions under the draft ATO view. Indeed, borrowing costs or establishment fees will rarely be minimal or nominal in the sense these terms have been interpreted by the ATO, certainly for larger loan amounts. It would be a perverse outcome if simply the quantum of a third-party loan (all other things being equal) meant that the TPDT was not available.
- funding a range of other potential 'capital management activities' to any extent with proceeds from third party loans (including 'recycled' proceeds from such loans), for example costs of issuing equity, IPO or privatisation costs, costs of undertaking a share or unit split or consolidation, demerger costs, costs of issuing listed debt or hybrid securities etc.
- refinancing an existing third party loan on completion of construction with a larger third party loan based on the value of the completed property, and returning capital to investors – this clearly seems to be prohibited under the ATO view, creating a clearly anomalous outcome that the developer of the property is restricted in the amount of third party debt it may borrow, as compared to an entity that borrows from a third party to acquire a completed property (which presumably would be a 'commercial activity' under the draft ATO view).
- in circumstances where:
    - a trust, for example, has derived an amount of earnings equal to or exceeding the amount of the distribution to be paid during an income year;
    - the trust has not retained any cash earnings on deposit, but has instead used cash received to pay down other existing interest-bearing debt in order to reduce the overall interest cost for the trust during the income year;
    - the trust then redraws the cash which it had used to pay down the interest-bearing debt which constitutes the issue of a debt interest for the purposes of the TPDT.

  Had the trust merely retained the cash to pay the distribution, there would be no borrowing in respect of the distribution that would be subject to the TPDT. However, the retention of cash results in higher interest costs and greater interest deductions – if cash earnings received during an income year are not used to pay down existing external interest-bearing debt (that otherwise satisfies the TPDT), interest costs in respect of that external debt would increase which would in turn result in greater interest deductions. In addition, the amount of interest income derived from quarantining cash from operations in a deposit account would be less than the interest expense payable. Being required to adopt such an approach in circumstances where there is no mischief seems non-sensical.
- other activities that are not 'Australian operations of trade or business capable of generating profit', noting that the activities identified by the ATO are only examples of such activities.

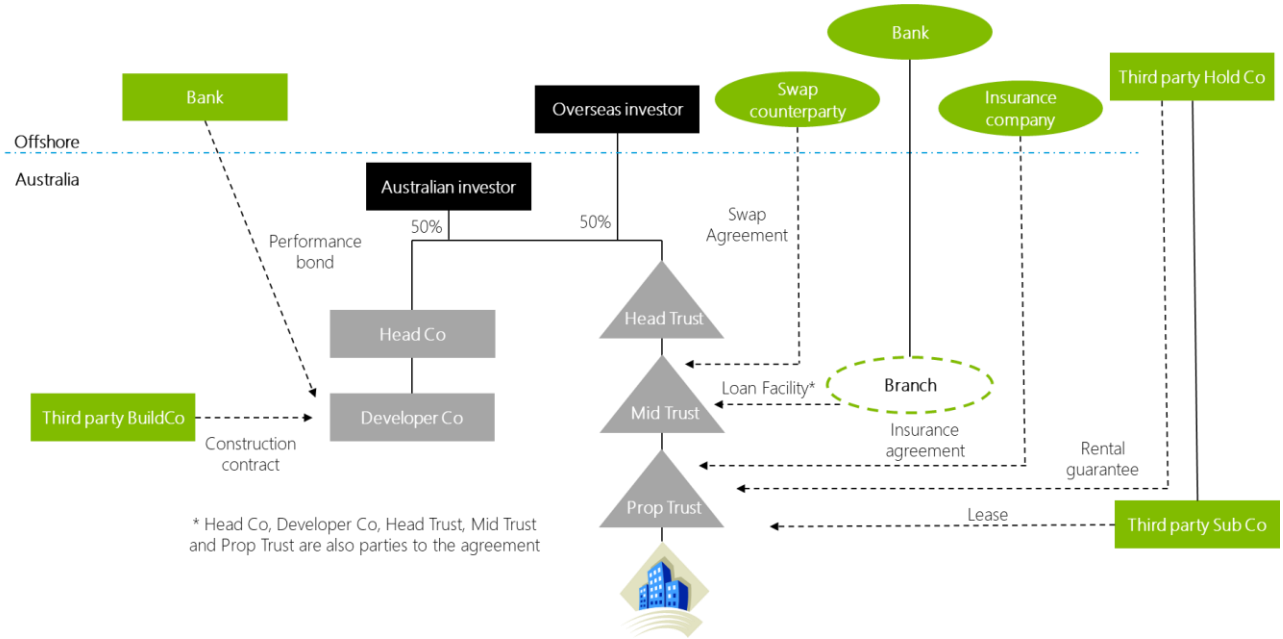
More generally, the requirement to determine (and evidence) how proceeds are 'used' within the Australian business of itself creates uncertainty, as identified in relation to other aspects of the new interest limitation rules, for example the DDCR. Under the draft ATO view it would be necessary to show that no more than a 'minimal or nominal' amount of any proceeds were 'used' for capital management activities.

By requiring that virtually none of the proceeds are 'used' to fund a distribution, the draft ATO view is effectively creating a new debt deduction creation rule for third party debt (whereas the DDCR specifically does not apply where the TPDT choice has been made), as demonstrated by Example 16 in the Draft Ruling. However, because no debt deductions are allowable where any of the TPD conditions are not satisfied, the impact is more extreme than the DDCR (which operates only 'to the extent' the proceeds were used in an impermissible way).

While the ATO may perceive an integrity risk associated with increasing third party debt (although where the TPD conditions are met it is genuinely hard to understand any such concerns), the legislation does not include a rule to this effect. Indeed, during the course of the development of the legislation the potential for the DDCR to operate in respect of an entity that had made a TPDT choice was deliberately removed. The clear intention of Parliament that the DDCR will not apply where a TPDT choice has been made should not effectively be defeated by the ATO adopting a strained interpretation of the expression 'commercial activities in Australia' which finds no basis in policy or in the context of the legislation as enacted.

Example involving group with only Australian operations

The following example illustrates the compliance costs, inequity and uncertainties associated with the draft ATO views in relation to the term 'Australian assets' and the expression 'commercial activities in connection with Australia' in relation to a group that only has Australian operations, where it would be expected that the application of these tests should be straightforward.



In this example the Australian group is subject to the thin capitalisation rules on the basis that it has an overseas investor that holds 50% of the shares and units in HeadCo and Head Trust. The group has no foreign permanent establishments and does not invest in associate entity debt, controlled foreign entity equity or controlled foreign entity debt.

Head Co is the head company of a tax consolidated group of which Developer Co is a member. Developer Co carries on residential development activities in Australia. Developer Co has entered into a construction contract with an Australian third party, BuildCo. BuildCo has procured a performance bond to be issued to Developer Co from an offshore third-party bank to ensure project completion.

Mid Trust holds the units in Prop Trust, which invests in a commercial property in Australia. Mid Trust has entered into a loan facility and issued debt to an offshore third-party bank that operates in Australia through an Australian permanent establishment. The third party bank has recourse for payment of the debt to all of the assets of Mid Trust, Prop Trust, Head Co and Developer Co, a mortgage over the commercial property, and security over the units in Mid Co held by Head Trust and shares in Developer Co held Head Co. Mid Trust has also entered into an interest rate swap with an offshore third party swap counterparty.

Prop Trusts owns a commercial property in Australia and has entered into a lease with a third party, Sub Co. The parent of Sub Co is an offshore third party, Hold Co. Hold Co has provided Prop Trust with a rental guarantee to secure the payment of rent by Sub Co. Prop Trust has also entered into an insurance contract in relation to the Australian commercial property with an offshore third-party insurance company.

During the year Mid Trust refinances with the same Australian permanent establishment of the offshore third-party bank (without any changes to recourse). The debt interest issued under the new loan facility includes an amount relating to establishment fees of 1.5% of the new loan facility amount (the establishment fees are not minimal or nominal). The value of the Australian commercial property has increased substantially and, in order to maximise returns to investors, the new loan facility amount is higher than the previous loan facility. The facility agreement permits repayments and redraws without penalty and Mid Trust takes advantage of this to reduce its interest costs by applying all available cash to repay loans and redrawing under the loan facility to meet cash requirements as they arise.

At the end of the year, Prop Trust pays a distribution to Mid Trust which pays a distribution to Head Trust, and Head Trust pays a distribution to the Australian investor and the offshore investor.

Based on the draft ATO view, the following assets would need to be 'carefully considered' to determine whether they were non-Australian assets:

- Performance bond issued to Developer Co by an offshore third party Bank
- Mid Trust facility agreement with an offshore third party bank that operates in Australia through an Australian permanent establishment.
- Mid Trust interest rate swap with an offshore third party swap counterparty
- Prop Trust rental guarantee with an offshore third party Hold Co
- Prop Trust insurance contract with an offshore third party insurance company
- Shares in Developer Co held by Head Co.
- Units in Mid Trust held by Head Trust
- Units in Prop Trust held by Mid Trust

To the extent there was a risk that any of these assets were not Australian assets based on the draft ATO view, market valuations of the assets would need to be undertaken to consider whether the compliance approach in the Draft PCG may be available (although limited to income years starting on or after 1 July 2023 and ending on or before 1 January 2027 and seems to require that a 'restructure' occurs to remove recourse to these assets). As it would not be possible to 'restructure' many of these assets (at least without incurring significant costs and increasing commercial risks), the compliance approach may not be available in any event and the TPD conditions would then be failed if there were any non-Australian assets with a value that was more than minimal or nominal. If the recourse of the third party bank could be expressly limited to remove recourse to potential non-Australian assets based on the draft ATO view, there would likely be substantial upfront fees charged by the third party bank to amend the facility agreement (which could not be funded by a drawdown under the facility agreement – refer below), and an increase in the interest rate that the third party bank would charge to Mid Trust.

Assuming the compliance approach was potentially available for any non-Australian assets, assessing access to this would involve market valuations of the rights under the agreements to confirm that each is less than $1m, as well as a market valuation of all of the assets to which the holder of the debt interest has recourse for the payment of the debt to satisfy the 1% threshold. However, to the extent that any assets are credits support rights (arguably this would include the performance bond and rental guarantee), the compliance approach would not be available and the TPD conditions would be failed if these were non-Australian assets and the value was more than minimal or nominal. Even if available initially, the compliance approach would cease to apply for the income year ending 30 June 2027 and following, and the TPD conditions would be failed thereafter where the value of any non-Australian assets was more than minimal or nominal (i.e. any new agreements involving non-residents would need to be scrutinised to try and manage this risk).

Mid Trust would also need to consider whether the use of proceeds from the new loan to repay the old loan and to pay establishment fees are each commercial activities in connection with Australia.

Based on the draft ATO view, funding establishment fees would not be commercial activities, and, as the fees are not minimal or nominal, would result in a failure of the TPD conditions.

Mid Trust would also need to consider whether the refinancing of existing loans represented commercial activities, which may involve assessing the use of the proceeds of the existing loans. If Prop Trust cannot evidence that all (other than a minimal or nominal amount) drawdowns under the previous loan facility were used in commercial activities in connection with Australia, the TPD conditions would be failed. If we assume that the previous loan facility was entered into 5 years previously, and also provided for repayments and redraws, Prop Trust would be unlikely to meet this requirement or at least would be unlikely to be in a position to discharge the burden of proof in respect of meeting this requirement, resulting in a failure of the TPD conditions. Requiring Prop Trust to have maintained evidence of the use of proceeds of each drawdown prior to the introduction of the new thin capitalisation legislation and the release of the draft ATO view in

respect of commercial activities is clearly inequitable and prejudices groups with existing loan arrangements.

Assuming the refinancing of the previous loan facility represents commercial activities, going forward, for the new loan facility Mid Trust would need to evidence that the proceeds of each drawdown was not used to fund capital management activities, for example the payment of interest, bank fees or distributions. To meet any payments associated with capital management activities, Prop Trust would therefore need to maintain a separate bank account where receipts of the business were deposited. Normally Prop Trust would have repaid the third party loan with such funds to reduce its interest costs, but due to the draft ATO views, Prop Trust would be required to incur higher interest expenses by not repaying the loan with available cash (such higher interest costs would exceed interest income derived on cash deposits at a lower interest rate). Even in this case it is not entirely clear that the proceeds of the new loan were not 'used' to fund the distribution, based on the draft ATO view in Example 2 of the Draft PCG in relation to the DDCR (where it seems that the draft ATO view may be that paying a distribution with operating cash flows rather than repaying a loan could result in the loan 'facilitating' the payment of the distribution).

The key point to emphasise in this example is that **there are no thin capitalisation integrity risks associated with a purely Australian business**, yet the example highlights the very substantial risk that the TPD conditions cannot be met in this situation.

Even in a 'best case' scenario, the TPD conditions can only be met by the Australian business incurring higher costs of funding (perversely increasing debt deductions) due to the bank specifically having no recourse to any potential non-Australian assets per the draft ATO view (less recourse results in higher interest costs), as well as upfront fees that would be charged by the bank to permit amendments to the facility agreement, and:

- being required to allocate significant resources and incurring costs to try to assemble records potentially going back many years in respect of any third party loans that are on issue or that will be refinanced (although even then, this may practically be impossible (e.g. depending on records available and level of detail available in records that would have been created many years prior i.e. in the absence of knowing that they would be needed to support tracing under the future TPDT rules)
- reviewing and trying to assess each contract or membership interest that is potentially a non-Australian asset under the draft ATO view (albeit significant uncertainty would likely remain, given the lack of practical guidance)
- undertaking valuations of contracts that could potentially be non-Australian assets prior to implementing any required 'restructure'
- undertaking 'restructures' involving negotiating limitation of recourse with third party lenders (if possible), incurring bank fees and higher funding costs going forward
- meticulously maintaining multiple bank accounts and implementing strict controls relating to which bank account is the source of payments made by the group to third parties, increasing interest costs
- ensuring any new contracts involving non-residents was carefully considered to try and ensure that the group was not acquiring any potential new non-Australian assets.

If the overseas investor sold 15% of its shares and units in Head Co and Head Trust to a new Australian investor (which would not require changes to any of the existing arrangements of the Australian group, as none of these arrangements involve the investors), the thin capitalisation rules would no longer apply and the above commercial costs, increased risks and onerous ongoing compliance requirements could be avoided. Clearly the draft ATO view can therefore operate to arbitrarily distinguish and penalise certain groups carrying on identical Australian operations.

Applying the recommendations set out above, the analysis in this example would be that the Australian group only carries on commercial activities in Australia, as the group does not carry out any excluded foreign activities (being any business carried on at or through its overseas permanent establishments or the holding of any controlled foreign entity debt or controlled foreign entity equity) and that therefore the assets of the Australian group are Australian assets. This is entirely appropriate and does not result in any integrity risks, and is in line with the EM and context of the TPDT rules. Importantly, the remaining TPD conditions must still be met, for example that the bank does not have recourse for payment to an asset being a credit support right that provides recourse, directly or indirectly, to assets of a non-Australian associate entity (which would be satisfied in this example).

2. Swaps

Both the Draft Ruling and the Draft PCG include comments and/or examples in relation to the treatment of swaps, both in a general sense, in the context of the TPDT and where (implicitly) the conduit financing modifications apply.

Interest rates swaps (included as part of currency swaps) are obviously very common financial arrangements necessary to appropriately manage risk, and the interpretation and practical application of the rules by the ATO should facilitate the operation of swap arrangements in a range of circumstances where there is no policy rationale for denying deductions under swaps, including:

- 'back-to-back' interest rate swaps with a related party (i.e. back-to-back with a third party interest rate swap)
- third party swaps hedging interest rate risk in respect of more than one debt interest
- cross currency interest rate swaps.

The draft views of the ATO in the Draft Ruling and Draft PCG create a number of issues in this regard, as set out below.

2.1 On-swaps and debt deductions attributable to a debt interest

RECOMMENDATION 2.1

The ATO should remove Example 1 from the Draft Ruling until it issues appropriate guidance on the conduit financing rules. Example 1 is a scenario that should clearly contemplate the conduit financing rules yet the Draft Ruling is predicated on the basis "the rules are outside the scope of this Ruling" (para 7). Including Example 1 results in confusion for taxpayers without analysis of the conduit financing rules.

As part of this guidance, or if the example is retained, the ATO should (as a reasonable concession) provide that taxpayers can apply the rules on the basis that only any net payment under an on-swap is non-deductible.

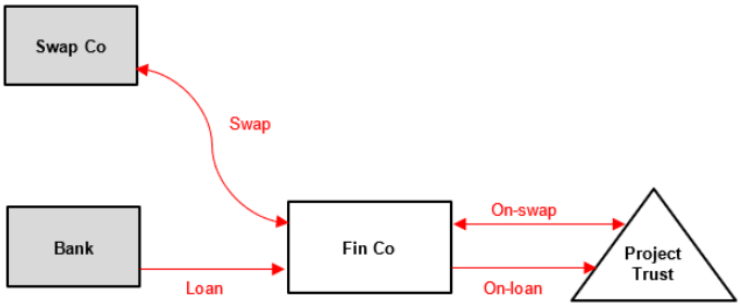
Example 1 in the Draft Ruling should clarify that where the terms of the on-swap provide for a payment of a net amount, that only the deductibility of this amount is required to be considered.

The Draft PCG should include a safe harbour to allow the terms of an on-swap to be amended to provide for a net payment.

Example 1 in the Draft Ruling relates to swap payments under an 'on-swap' arrangement between a Fin Co and an associate entity, setting out that payments by Fin Co and by the associate entity under the payment leg of the on-swap are non-deductible. That is, deductibility of the gross payments under the on-swap are considered. The example does not specifically deal with a situation where the on-swap provides for payment of a net amount.

The overall outcome for (say) a Fin Co that has entered into an on-swap arrangement is that the payment leg is non-deductible, but the receipt leg is assessable. For the ultimate borrower, again, the payment leg is non-deductible, but the receipt leg is assessable.

Using the facts in Example 1 in the Draft Ruling, assuming the Bank Loan meets the TPD conditions:



	(Payment)/ Receipt	Denied deduction	Taxable income
Fin Co			
Payment leg – Swap Co	(100)		(100)
Receipt leg – Swap Co	90		90
Payment leg – Project Trust	(90)	90	
Receipt leg – Project Trust	100		100
Total	**Nil**		**100**
Project Trust			
Payment leg – Fin Co	(100)	100	
Receipt leg – Fin Co	90		90
Total	**(10)**		**90**
Total - group	**(10)**		**190**

This illustrates the overall taxable income of the group of $190 associated with a net payment to a third party Swap Co of $10. A more equitable outcome (consistent with the legislative provisions generally not permitting deductions for swaps with associate entities) would be for the net payment by Project Trust of $10 to be denied.

The ATO should (as a reasonable concession) provide that taxpayers can apply the rules on the basis that only any net payment under the on-swap is non-deductible.

In any event, Example 1 in the Draft Ruling should be removed until the ATO can provide suitable guidance on the application of the conduit financing rules in this scenario. As part of this guidance, or if the example is retained, the ATO should also clarify that where the terms of the on-swap provide for a payment of a net amount, that only the deductibility of this amount is required to be considered, and the Draft PCG should include a safe harbour to allow the terms of an on-swap to be amended to provide for a net payment.

2.2 On-swaps imbedded in a relevant debt interest

RECOMMENDATION 2.2

The Draft Ruling should confirm that a term imbedded in an on-loan requiring on-payment of swap receipts by a conduit financer or conduit borrower is disregarded under paragraph 820-427C(2)(d) or paragraph 820-427C(2)(e), as relevant, being the same 'term' of the on-loan that has 'the effect of allowing … the recovery of costs' of the conduit financer or conduit borrower.

Assuming that the on-swap in Example 1 in the Draft Ruling is restructured such that the terms are imbedded in the relevant debt interest (as contemplated by Example 26 of the Draft PCG), it would be expected that debt deductions relating to the imbedded on-swap would be included in the third party earnings limit and therefore deductible in full to Fin Co and to Project Trust.

However, it is not clear how paragraph 820-427C(2)(d) applies to the on-loan in respect of the requirement to make an on-payment of an amount received by Fin Co under the third-party arrangement. As shown above, each swap has a receipt leg and a payment leg, and therefore Fin Co will have a payment obligation to Project Trust. In order for paragraph 820-427C(2)(d) to facilitate a restructure as contemplated by Example 26 of the Draft PCG, the obligation of Fin Co under the payment leg of the on-loan with Project Trust must be disregarded for the purposes of determining whether the on-loan meets the 'same terms' requirement.

This would be equally applicable where only a net imbedded on-swap payment is required to be considered (see Recommendation 2.1), in order to cover a situation where the third party swap entered into by Fin Co is 'in the money' (i.e. Fin Co is entitled to a net receipt from the third party Swap Co and has on obligation under the on-loan to on-pay this amount to Project Trust).

The ATO guidance should therefore confirm that 'the term' under a relevant debt interest that has the effect of allowing the recovery of costs of the conduit financer or conduit borrower is the same 'term' that requires the conduit financer or conduit borrower to on-pay swap receipts and is therefore disregarded for both purposes pursuant to paragraph 820-427C(2)(d) or paragraph 820-427C(2)(e), as relevant.

2.3 Restructure of on-swaps

RECOMMENDATION 2.3

The ATO should update Example 26 of the Draft PCG to clarify that not recognising any gain or loss for tax purposes on closing out a swap should not be a requirement to access the compliance approach.

Additionally, or alternatively, the Draft PCG should include an example involving amendment of the terms of the on-swap such that there is no amount payable on close-out in respect of the value of the on-swap, and amendment of the terms of the on-loan so as to imbed the existing value of the on-swap (i.e. such that realisation of any gain or loss under the on-swap is deferred until the corresponding third party swap is closed out).

Example 26 in the Draft PCG involves closing out a related party swap and amending the terms of an existing debt interests so that it is a debt interest under which interest payable by Asset Trust is the same rate as the debt interest issued by Fin Co to Bank adjusted by the amounts payable under the interest rate swap.

The example continues by noting that:

> *265. Fin Co and Asset Trust do not recognise any gain or loss for tax purposes when closing out the swap.*

Whether a gain or loss arises for tax purposes on closing out the swap is not something that can be controlled as part of the restructure, it will depend on the terms of the swap and existing market conditions, however it is likely that there would be a gain or loss. Accordingly, closing out the swap without recognising any gain or loss for tax purposes should not be a requirement to access the compliance approach.

Additionally, the Draft PCG should include an example involving amendment of the terms of the on-swap such that there is no amount payable on close-out in respect of the value of the on-swap (i.e. to the extent the on-swap is 'in the money' / 'out of the money' from Fin Co and Asset Trust's perspective), and amendment of the terms of the on-loan so as to imbed the existing value of the on-swap without requiring any amount payable by Fin Co or Asset Trust until the close-out of the corresponding third party swap (i.e. such that realisation of any gain or loss under the on-swap is deferred until the corresponding third party swap is closed out). This reflects the outcome that would have arisen prior to the thin capitalisation amendments had the back-to-back swap remained on foot.

Whilst there may be an indirect value shift based on each of the amendment to the on-loan and the amendment to the on-swap, the increase and decrease would be the same (i.e. no change in the value of membership interests in Fin Co or Asset Trust).

2.4 Swaps attributable to multiple debt interests

RECOMMENDATION 2.4

The Draft Ruling should confirm that debt deductions under an interest rate swap that hedges more than one debt interest are 'directly associated with hedging or managing the interest rate risk' in respect of each relevant debt interest. Accordingly, where each relevant debt interest meets the TPD conditions, subsection 820-427A(2) should operate to deem all debt deductions under the swap to be attributable to a relevant debt interest.

It is not uncommon for an interest rate swap to be entered into that hedges more than one debt interest on issue, using a fixed rate swap that hedges a blended variable rate across those debt interests. Such hedging arrangements hedge or manage interest rate risk in the same way as separate interest rate swaps for each debt interest and should be treated in the same way for tax purposes.

Debt deductions under an interest rate swap that hedges more than one debt interest are 'directly associated with hedging or managing the interest rate risk' in respect of each relevant debt interest. Accordingly, where each relevant debt interest meets the TPD conditions (and the debt deductions are not referable to an amount paid or payable, directly or indirectly, to an associate entity), subsection 820-427A(2) should operate to deem all debt deductions under the swap to be attributable to a relevant debt interest.

This view is supported by the expression 'to the extent that' as used in subsection 820-427A(2), which makes it clear that debt deductions under a swap may be deductible to an extent based on hedging one debt interest and also deductible to an extent based on hedging one or more other debt interests. That is, whilst subsection 820-427A(2) could be seen to operate on a 'debt interest by debt interest' basis, the application of subsection 820-427A(2) to multiple debt interests being hedged by a single swap can accommodate debt deductions being available in full under that swap.

2.5 Cross currency interest rate swaps

RECOMMENDATION 2.5

The Draft Ruling should confirm that a debt deduction under a cross currency interest rate swap is directly associated with hedging or managing interest rate risk if it is part of an arrangement that achieves this result, even where the arrangement also operates to hedge or manage currency risk.

Another relatively common hedging arrangement involves a cross currency interest rate swap, which hedges or manages both currency risk and interest rate risk. Such arrangements hedge or manage interest rate risk in the same way as a separate interest rate swap and, to that extent, should be treated in the same way as a separate interest rate swap.

An entity may have a debt deduction that represents a cost in relation to the interest rate swap component of a cross currency interest rate swap. Under the cross currency interest rate swap there may also be a cost associated with the currency component of the cross currency interest rate swap which is not a debt deduction, on the basis that such costs are not 'interest, an amount in the nature of interest, or any other amount that is economically equivalent to interest' and do not arise under a debt interest.

The thin capitalisation rules can only operate to deny a deduction under a cross currency interest rate swap to the extent that it relates to an interest rate swap (i.e. to the extent it gives rise to a debt deduction). That is, if an interest rate swap cannot be identified as part of a cross currency interest rate swap the thin capitalisation rules have no scope to operate.

The debt deduction (relating to the interest rate swap component) should then fall for consideration under subsection 820-427A(2). It should be treated as attributable to a debt interest that satisfies the TPD conditions where the debt deduction is 'directly associated with hedging or managing the interest rate risk' in respect of a debt interest that satisfies these conditions. The debt deduction should be treated as directly associated with hedging or managing interest rate risk if it is part of an arrangement that achieves this result, even where the arrangement also operates to hedge or manage currency risk.

3. 'Minor or insignificant' and 'all or substantially all'

RECOMMENDATION 3

3.1 The Draft Ruling should clarify that whether something is "minor" or "insignificant" is properly a question of fact depending on a particular taxpayer's circumstances, and that the question of whether something is "insignificant" should be considered in light of whether recourse to the asset is significant to the terms of the third-party debt interest.

3.2 The PCG compliance approach be applied:

- ***to all assets (i.e. not excluding credit support rights) for the purposes of the term 'Australian assets' where:***
  - ***The market value of those assets is less than 2% of all of the assets to which the holder of the debt interest has recourse for the payment of the debt; or***
  - ***The market value of each asset (or bundle of identical assets, such as a shareholding) does not exceed $5 million.***
- ***in respect of the 'use' of proceeds for the purposes of the term 'all or substantially all' where:***
  - ***The uses identified are less than 2% of all of the uses of the proceeds; or***
  - ***Each use does not exceed $5 million.***

This compliance approach should also continue to be available after the end of the income year in which the Draft PCG is finalised.

We maintain the view that whether something is "minor" or "insignificant" is properly a question of fact depending on a particular taxpayer's circumstances. In addition, the term should be interpreted as including something that is either minor or insignificant (that is, the term should not conflate the words minor and insignificant as a single requirement).

Ultimately the question of whether something is "insignificant" should be considered in light of whether recourse to the asset is significant to the terms of the third-party debt interest. Where recourse to the ineligible asset(s) does not reasonably impact on the quantum of third-party debt, the interest rate and other lending terms relating to costs, such that the borrower benefits from debt deductions that would not be available if the third-party lender did not have recourse for payment to the ineligible asset(s), the ineligible asset(s) should be considered "insignificant".

The view in the Draft Ruling that the terms 'minor or insignificant' and 'all or substantially all' each mean a 'minimal or nominal' value or amount significantly increase compliance costs associated with determining whether the TPD conditions have been satisfied in relation to each income year.

The Draft PCG then provides a compliance approach for 'Australian assets' available for income years starting on or after 1 July 2023 and ending on or before 1 January 2027 where:

- *You make reasonable efforts to identify minor or insignificant assets of the obligor group that are not Australian assets and both of the following apply*

    - *The market value of those assets identified is less than 1% of all of the assets to which the holder of the debt interest has recourse for the payment of the debt.*
    - *The market value of each asset (or bundle of identical assets, such as a shareholding) does not exceed $1 million.*
- *None of those assets are credit support rights.*

Neither the legislation, the EM or the Supplementary state that 'minor or insignificant' and 'all or substantially all' mean a 'minimal or nominal' value or amount.

In relation to 'all or substantially all' the EM provides:

> *2.30 … The term 'all, or substantially all' is adopted to cover circumstances where all of the entity's profits are derived from that business but accommodating other **minor or incidental profits**.*

In relation to 'minor or insignificant' the Supplementary EM provides:

> *1.30 … This allowance is intended to prevent paragraph 820-427A(3)(c) being contravened for **inadvertent and superficial reasons**.*

Accordingly, the 'safe harbour' should accommodate reasonable interpretations that were open based on the legislation, EM and Supplementary EM. It is suggested that a reasonable approach would apply:

- to all assets (i.e. not excluding credit support rights) for the purposes of the term 'Australian assets' where:
    - The market value of those assets is less than **2%** of all of the assets to which the holder of the debt interest has recourse for the payment of the debt; **or**
    - The market value of each asset (or bundle of identical assets, such as a shareholding) does not exceed **$5 million**.
- in respect of the 'use' of proceeds for the purposes of the term 'all or substantially all' where:
    - The uses identified are less than 2% of all of the uses of the proceeds; or
    - Each use does not exceed $5 million.

This compliance approach should also continue to be available after the end of the income year in which the Draft PCG is finalised for the following reasons:

- to avoid the TPD conditions being failed in respect of minor or incidental profits, or for inadvertent and superficial reasons.
- to reduce the very high compliance costs associated with the view in the Draft Ruling, consistent with the objectives of the TPDT as a simpler test to apply than the previous ALDT.
- alleviate costs associated with obtaining market values for certain assets that clearly have a market value of less than $5 million (but could potentially have a value in excess of $1 million).
- as a reasonable balance between:
    - the highly material tax implications of failing <u>any</u> of the TPD conditions (i.e. <u>nil</u> debt deductions being available) and
    - the risk that higher levels of debt would actually be available / commercially desirable due to recourse to the asset or the use of the proceeds being permitted (which would be very low based on the thresholds proposed above).

That is, the actual cost to revenue of extending the compliance approach as suggested will be nil unless the third party lender is willing to lend <u>and</u> the borrower wants to borrower, a higher amount as a result. In reality, it is very unlikely that an entity would seek to borrow

the absolute maximum amount that it could borrow from a third party due to the risk of future breaches of lending conditions, such that the actual impact on levels of third party borrowing that would result from the ATO providing the suggested compliance approach would be expected to be negligible, while the compliance savings would be significant.

4. Recourse for payment of the debt

A number of issues still arise in relation to the 'recourse for payment of the debt' requirement under paragraph 820-427A(3)(c) of the TPD conditions, as set out below.

4.1 Recourse for payment of the debt - membership interests in the borrower

RECOMMENDATION 4.1

The ATO should confirm that the exception for recourse for payment of the debt to membership interests covers all rights inherent in the ownership of the membership interests.

For the purposes of subsection 820-49(1) recourse for payment of the debt to membership interests in the borrower is disregarded and similarly for the purposes of paragraph 820-427A(4)(b) recourse for payment of the debt to membership interests in the borrower is generally permissible recourse.

In practice, the third-party lender may have recourse for payment to assets being rights associated with the ownership of membership interests, for example:

- rights to proceeds on disposal of the membership interests
- rights to unpaid distributions
- rights to bonus shares/units
- rights under any entitlement issue

In order to operate effectively, guidance should be provided to confirm that the exception for recourse for payment of the debt to membership interests covers all rights inherent in the ownership of the membership interests.

4.2 Recourse for payment of the debt – credit support rights

RECOMMENDATION 4.2

The ATO should clarify that implicit credit support is not relevant to the TPD conditions.

Footnote 49 of the Draft Ruling provides that the expression 'guarantee, security or credit support'

carries the same meaning as in former paragraphs 820-105(2)(e) and 820-215(2)(e) and then refers to paragraphs 71 to 74 of Taxation Ruling TR 2020/4. This could be taken to imply that implicit credit support needs to be considered as a credit support right.

> *73. Any explicit form of support (for example, a formal guarantee provided by a parent) or implicit credit support (such as a non-binding letter of comfort or an incidental benefit from the entity's passive affiliation with the multinational group to which it belongs) is to be disregarded. The provision does not seek to distinguish between contractual and non-contractual forms of support and should be given a broad meaning.*

Former paragraphs 820-105(2)(e) provided that the following needed to be disregarded in determining the arm's length debt amount:

> *(e) any guarantee, security or other form of credit support provided to the entity in relation to the Australian business during that year:*

This can be contrasted with the expression used in subsection 820-427A(5) being '**a right** under or in relation to a guarantee, security or other form of credit support'. Implicit credit support is not a "right". This is a key drafting distinction between former paragraphs 820-105(2)(e) and 820-215(2)(e) and subsection 820-427A(5) and this should be acknowledge in footnote 49 of the Draft Ruling.

5. Availability of compliance approaches

RECOMMENDATION 5

The ATO should confirm that more than one PCG compliance approach can be available to the same entity where other requirements are met.

The Draft PCG sets out a range of common requirements for the compliance approaches in the Schedule, including that "prior to and following any restructure, the original arrangement satisfies the third party debt conditions (other than the condition to which the compliance approach applies)."

On a strict reading this suggests that an entity may not apply more than one of the compliance approaches. There is no obvious rationale as to why each compliance approach should not be available independently, and therefore the PCG should clarify that the requirement is that "prior to and following any restructure, the original arrangement satisfies the third party debt conditions (other than the condition***s*** to which ***a*** compliance approach applies)."

6. Conduit financing rules

RECOMMENDATION 6

The ATO should provide an ongoing compliance approach permitting the conduit financer modifications to apply in the following 'low risk scenario':

- ***a conduit financer is operating on a break-even basis (i.e. the conduit financers debt deductions (including swap costs), and other costs (including administrative costs) are fully recovered from associate entities)***
- ***all the debt interests issued by the conduit financer satisfy the TPD conditions, and***
- ***all costs under interest rate swaps entered into by the conduit financer are attributable to debt interests that satisfy the TPD conditions.***

There are a range of critical issues that need to be addressed by way of ATO guidance as a high priority to enable the conduit financer rules to have any meaningful application in the context of non-tax consolidated groups (including stapled structures). These issues, and the required ATO guidance, are set out below, however as a fundamental point, the conduit financing modifications should be available to facilitate a deduction under on-lending and on-swap arrangements in the following 'low risk scenario':

- a conduit financer is operating on a break-even basis (i.e. the conduit financers debt deductions (including swap costs), and other costs (including administrative costs) are fully recovered from associate entities)
- all the debt interests issued by the conduit financer satisfy the TPD conditions, and
- all costs under interest rate swaps entered into by the conduit financer are attributable to debt interests that satisfy the TPD conditions.

Whilst the Draft PCG does provide for compliance approaches to:

- remove any margin on on-lending arrangements
- split on-lending so that each debt interest issued by a conduit financer is matched by a separate loan from the conduit financer to an associate entity, and
- amend the terms of on-lending agreements to build in swap costs

the resulting arrangements are practically extremely difficult to manage on an ongoing basis resulting in high compliance costs and significant risks of inadvertent breaches of the strict requirements (resulting in nil debt deductions being available).

A compliance approach should be available on an ongoing basis covering the 'low risk scenario' set out above, without requiring extensive restructuring of existing agreements (noting the various issues discussed above in relation to the compliance approaches under the Draft PCG) and fastidious management of multiple on-lending arrangements with embedded swaps to strictly adhere to the same terms requirement on a debt interest by debt interest basis. Some of the genuinely problematic practical issues and additional costs associated with a strict application of the conduit financing requirements are discussed below.

In the above 'low risk scenario', groups that are required to meet the conduit financing requirements will suffer higher borrowing costs (and therefore generate higher deductible interest costs) under third party loans than a group that has issued third party loans in otherwise identical circumstances but is not subject to these strict requirements. Emphasising that there is absolutely no 'integrity' issue with permitting the conduit financer modifications to apply in the 'low risk scenario' above, the ATO should provide an ongoing compliance approach to ensure a level playing field as between Australian entities seeking to fund their Australian operations with genuine third party debt.

Financed only with proceeds for the ultimate debt interest

To satisfy paragraph 820-427C(1)(c), the relevant debt interest must be "financed" by the conduit financer or the conduit borrower "only with proceeds from the ultimate debt interest". This requirement gives rise to potential issues in a number of situations:

- In practice, external debt facilities and on-lending is not put in place by conduit financers on a transaction-by-transaction basis. When external financing is put in place a conduit financer must manage both refinancing risk and debt costs for the group. This means, amongst other things, that the renewal of debt must be staggered.

- The essential nature of a conduit financer means that it will obtain financing from many sources and have external borrowings of different terms, and different interest costs. The funds lent by the conduit financer to 100% commonly owned Australian resident entities in the group at any given time may be for different amounts to any one ultimate debt interest (e.g. ultimate external debt interests may be aggregated or divided to amounts that suit the relevant borrowing needs within the Group). The conduit financer will also source and retire external funding sources at various times in the most effective manner (including prepaying debt from operating earnings and drawing down additional external funds within agreed facility debt limits on a needs basis) to minimise the cost of debt, ensure debt covenants are not breached and to manage cashflow requirements of the entire group's business. This reflects the intrinsic nature of conduit lending and borrowing arrangements (and money generally) as fungible in nature.

- External debt facilities may also be drawn to repay other existing third-party debt when it falls due or to reduce costs of borrowing based on market conditions. In this situation the amount on-lent from the refinanced external debt is not necessarily refinanced at the same time as the ultimate debt.

- Cash is not kept on hand to enable the repayment of debt between associates to match the repayment of the ultimate external debt. Likewise, cash is not kept on hand to fund distributions not due to be paid until later in the year. Any cash on hand will be used to reduce external short-term debt or facilities and redrawn at a later date as cash is needed. To do otherwise would increase both the debt costs and external debt of the group and this is not commercially viable.

- As debt between associates is repaid, the matching ultimate external debt may not be repaid as the terms may not allow for this or it may not be commercially preferable if for example more expensive external debt can be repaid.

- It is also difficult to see the need for a strict tracing approach, as all ultimate debt interests held by the group financier would satisfy the third-party debt conditions and the conduit financier's practice would be to on lend funds at a cost that is based on the total cost of the

ultimate debt. The EM itself acknowledges that the conduit financer, "can streamline and simplify borrowing processes for the group".

The term "in relation to [the relevant] income year" should be considered in the context of how an entity has "financed" the relevant debt interest for the purposes of paragraphs 820-427C(1)(c). That is, given the year-by-year nature of the third-party debt test it should be sufficient that the proceeds can reasonably be seen as financing the relevant debt interest in the relevant income year, rather than seeking to strictly trace a receipt of proceeds and the on-lending of these proceeds.

On this basis, where, in a relevant income year, in a situation where there is no conduit borrower:

- a conduit financer has on issue an ultimate debt interest
- at all times (in a practical sense) that the ultimate debt interest is on issue in the relevant income year, one or more relevant debt interests are on issue to the conduit financer and the sum of the quantum of the relevant debt interests issued to the conduit financer is equal to the quantum of the ultimate debt interest

the relevant debt interest should be treated as "financed" by the proceeds from the ultimate debt interest.

Where there is a conduit borrower, the same principle should apply to require matching of the quantum of the relevant debt interest issued by the conduit borrower with one or more relevant debt interests issued to the conduit borrower.

The "same terms" requirement would need to be satisfied by each relevant debt interest which ensures that there are no additional debt deductions available to the group as a result of the conduit financer modifications.

Same terms where there is more than one ultimate debt interest

Under paragraph 820-427C(1)(d), the terms of the relevant debt interest, to the extent that those terms relate to costs incurred by the borrower in relation to the relevant debt interest, must be the same as the terms of the ultimate debt interest, to the extent that those terms relate to such costs incurred by the conduit financer in relation to the ultimate debt interest.

In practice, the conduit financer may have multiple ultimate debt interests on issue but only a single relevant debt interest for administrative convenience.

In this regard, where the costs under the relevant debt interest are the same as the aggregate costs under the multiple ultimate debt interests issued by the conduit financer the "same terms" requirement should be met for the relevant debt interest.

In order to facilitate common conduit financing arrangements as outlined above, an interpretation is required that "the ultimate debt interest" in section 820-427C can be read as "one or more ultimate debt interests" and permitting an aggregation of the terms that relate to costs across

multiple ultimate debt interests to assess whether those terms are "the same" as the relevant debt interest.

There is no mischief apparent in taking a broader view of the scope of the term "ultimate debt interest" as the requirement in section 820-427C (including the "same terms" requirement) must still be met in order for a relevant debt interest to meet the third party debt conditions, and therefore there is no scope to claim debt deductions in excess of the debt deductions pursuant to the third party debt.

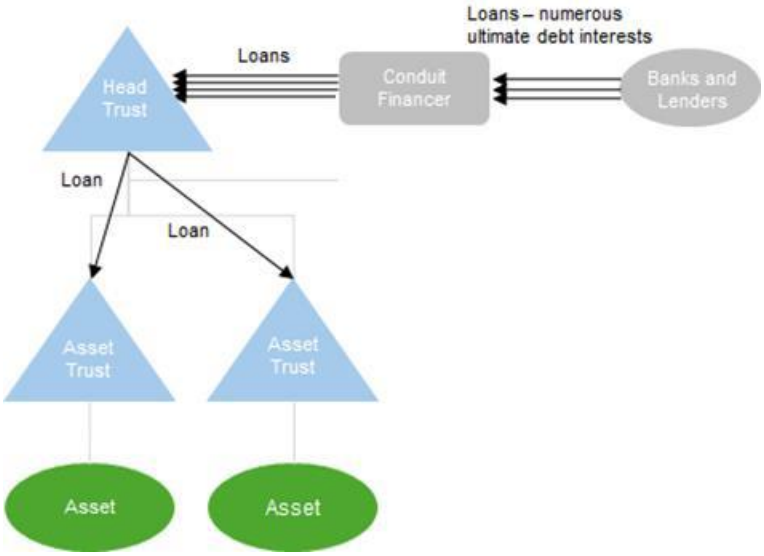
Same terms where there is more than one relevant debt interest and more than one ultimate debt interest

A conduit financier may have multiple relevant debt interests and multiple ultimate debt interests. If the conduit financer charges in respect of the multiple relevant debt interests the weighted average interest rate in respect of the multiple ultimate debt interests (i.e. the weighted average interest rate of the ultimate debt interests = interest cost of total ultimate debt interests/total ultimate debt interests) and this method is applied to all relevant debt interests, the total costs in respect of the relevant debt interests will equal the total costs of the ultimate debt interests. The "same terms" requirement should be met for the relevant debt interests. Should the ATO not accept that this approach would satisfy the "same terms" requirement, it would unjustly impact Australian groups that hold no offshore investments.

Example – same terms where there is more than one relevant debt interest and more than one ultimate debt interest

In this example, Conduit Financer borrows from various third-party banks and lenders. To efficiently manage the group's financing requirements and debt costs, external loans will be entered into at different times for different loan facility limits, varying terms (including some loans with the ability to repay and redraw funds within the agreed facility limit), interest rates, and costs. External borrowings will be sourced and retired at various times by Conduit Financer which will in total match the needs of Head Trust (and its wholly owned entities).

Conduit Financer makes multiple loans to Head Trust (which also lends to its wholly owned entities). External loans may not be backed to backed but rather are typically split / aggregated and on-lent to entities depending on their financial requirements. The loan terms also allow Head Trust (and its wholly owned entities) the ability to prepay and redraw funds as required. The interest rate on the relevant debt interests will reflect Conduit Financer's cost of funds on a monthly basis (i.e. Conduit Financer makes no margin).



As Conduit Financer aggregates its external debt interests and refinances to meet the financial requirements of Head Trust and its wholly owned entities, it would be a prohibitively onerous and an expensive requirement to exactly match each cost of borrowing by an entity in the group to an external loan. It is also practically impossible to trace the external source of each internal loan given revolving external facilities are continually repaid, redrawn, cancelled or replaced making the source of the ultimate funds indistinguishable over time.

A method which achieves a reasonable allocation of actual costs of the ultimate debt interests should be permitted, such as the weighted average interest rate in respect of the multiple ultimate debt interests.

Same terms and reasonable administrative costs

Conduit financers will typically be able to recover (for example) audit costs, income tax return preparation costs, or entity administration costs. These costs are entity costs that do not (in that sense) "relate directly to the ultimate debt interest", although they may be related to the ultimate debt interest (if, for example, the third-party financier required the conduit financer to have their accounts audited, or even more generally that those expenses arise as an incident of the conduit financer being established to issue ultimate debt interests).

ATO guidance should confirm in what circumstances administrative costs are considered to "relate directly to the ultimate debt interest".

Same terms and debt interests that do not give rise to debt deductions

Pursuant to paragraph 820-427C(1)(b), a “relevant debt interest” includes any debt interest that is issued by an associate entity to the conduit financer or a conduit borrower.

As a practical matter, an associate entity may have issued interest free loans to the conduit financer or conduit borrower, and such interest free loans may qualify as debt interests pursuant

to Division 974 (e.g. if repayable within 10 years). Such interest free loans arise due to the need to manage cash on a group basis and would often fluctuate on a regular basis.

This gives rise to the question of whether the requirement in paragraph 820-427C(1)(d) can be satisfied in respect of the interest free loan, i.e.:

> *(d) the terms of the relevant debt interest, to the extent that those terms* ***relate to costs incurred by the borrower*** *in relation to the relevant debt interest, are the same as the terms of the ultimate debt interest, to the extent that those terms relate to such costs incurred by the conduit financer in relation to the ultimate debt interest [emphasis added]*

As a matter of interpretation, ATO guidance should confirm that where the relevant interest does not give rise to any debt deductions there are no terms of the relevant debt interest that "relate to costs incurred by the borrower" and therefore the requirement in paragraph 820-427C(1)(d) is satisfied for relevant debt interests that do not give rise to debt deductions.

This will ensure that a group is not prevented from using the third-party debt test conduit financer modifications merely due to the existence of interest free loans, while fully preserving the intended effect of the third-party debt test and conduit financer modifications, i.e. the terms of a relevant debt that do relate to costs incurred by the borrower must be the same as the ultimate debt interest.

7. Credit support – Development concession

RECOMMENDATION 7.1

Consistent with the way a third party lender would often approach the provision of a development loan, the Draft Ruling should confirm that that development activities do not "cease" until all relevant assets reach income 'stabilisation' (for develop to hold assets) or have been sold (for develop to sell assets), (i.e. until the development loan can be repaid or refinanced).

If the ATO consider that such an interpretation is not available, the PCG should include an ongoing compliance approach such that the development asset concession can apply up to two years beyond the date of completion of construction to allow for income stabilisation, refinancing or sale of relevant assets.

RECOMMENDATION 7.2

The Draft Ruling should confirm that a credit support right can 'wholly' relate to creation or development of land AND 'wholly' relate to creation or development of relevant moveable property, and therefore the right can satisfy both subparagraphs 820-427A(5)(c)(iii) and 820-427A(5)(c)(iv).

Scope of "development" activities

The Draft Ruling provides the following comments on the operation of the development concession in subparagraphs 820-427A(5)(c)(iii) and 820-427A(5)(c)(iv):

> *133* [and 144]*. The connection between a credit support right and the creation or development of the relevant CGT asset must be tested continuously. For example, where a credit support right initially relates to the creation or development of a relevant CGT asset, but subsequently relates to other business activities (or otherwise subsists after the relevant creation or development activities have ceased), subparagraph 820-427A(5)(a)(iii) will no longer be satisfied.[60]*
>
> *134* [and 145]*. When the creation and development of a relevant CGT asset begins and ends is a question of fact that will vary depending on the nature of the asset and the relevant creation or development activities.*

These comments could be taken to suggest that the concession is not available following completion of construction of a relevant asset, however the comments also refer to development 'business activities'. In this regard, the business activity of development should not be seen to cease at the time that construction is completed but rather should extend to the time that the relevant third party bank would consider to be the end of the development activities in the circumstances, which may include a reasonable time following completion of construction to facilitate entering into leases in respect of the building (for example a build to rent development) or to enter into and settle sale contracts (for example in a build to sell development). Other examples are provided below.

Such an interpretation is not inconsistent with the words of subparagraphs 820-427A(5)(c)(iii) and 820-427A(5)(c)(iv), which refer to "a right that relates wholly to the creation or development of a *CGT asset". The credit support right under the development loan continues to relate wholly to the development even after the construction is completed on the basis that the loan is a development loan. Following development, the developer would seek to refinance the development loan to reduce interest costs. Any new loan would not be covered by the development concession.

Interpreting the scope of the concession based on the nature of the arrangement as a development loan facility (rather than physical construction) is more aligned with the context in which the concession appears, to facilitate third party lending arrangements in relation to development activities. In assessing the scope of development activities, the test should therefore look at the purpose of the loan and associated credit support, as a development loan. Development loans by their very nature have higher interest costs than loans secured against stabilised assets, given the increased risk taken on by the lender. Accordingly, it would be unlikely that taxpayers would be incentivised to seek to utilise this concession unless actually carrying on development activities.

In the context of the TPDT, a commercial approach should therefore be adopted in assessing the scope of the development activity, aligned with the approach of a third party lender providing a development loan facility.

The following examples highlight scenarios where a third party lender providing a development loan facility may typically require credit support beyond completion of construction:

1. A bank providing a development loan facility for a build-to rent project (or a develop to hold commercial property) requires credit support until there is enough rental income to cover the interest costs. As leases cannot be entered into for residential property while the property is under construction (or if insufficient pre-leasing is achieved for a commercial property), time is needed to enter into leases following completion (i.e. there will be a period of income stabilisation required post completion of construction during which credit support rights are required to be retained by the lender under the development loan).

2. Development loan facility for the construction of residential apartments for sale. The sales of individual apartments take place over a period of time post completion of construction. Sales proceeds are used to pay down the development loan. In other words, the development loan remains on foot and interest is paid post the construction of the CGT asset. Practically, it could take between several months or longer for settlement to take place. So long as the development loan continues to be paid down with sales proceeds the test should be satisfied.

3. Development loan facility for a fund that will involve the acquisition and construction of multiple assets. Given the capital is often deployed over a period of time as assets are identified, there could be a scenario where some assets may have completed construction, and potentially be earning income, whilst others are still under construction. This is practically unavoidable. In some cases, constructed assets roll off the development facility into an operating facility which would no longer have the credit support right, however, this does not always happen immediately post construction. As noted above, the owner is incentivised to refinance development funding of completed assets where possible to reduce interest costs.

4. Development loan facility to acquire an asset that has an existing tenant which generates rental income. The development loan is for the redevelopment of the asset however up to the point where construction begins, rental income is derived. In this case the purpose of the loan as a development loan should determine whether the test is satisfied. If the sole purpose of the loan and the credit support provided is for the development of new CGT assets then 5(a)(iii) should be satisfied. This should include scenarios where the rental yield is material vs immaterial, where the development starts within days/weeks vs several months, where development can only start once development approval is obtained which may take 6-18 months. The key point is that the loan is a development loan and the credit support required reflects the development risk.

If the ATO consider that such an interpretation is not available, the PCG should include an ongoing compliance approach such that the development asset concession for a development loan facility can apply up to two years beyond the date of completion of construction. While this may not cover all the examples above, it should cover the majority of the situations outlined, including providing

taxpayers with a reasonable period of time to refinancing development loans for completed assets that form part of a pool of development assets financed with a development loan.

Right covered by both subparagraph 820-427A(5)(c)(iii) AND 820-427A(5)(c)(iv)

The Draft Ruling should confirm that a credit support right can 'wholly' relate to creation or development of land AND 'wholly' relate to creation or development of relevant moveable property, and therefore the right can satisfy both subparagraphs 820-427A(5)(c)(iii) and 820-427A(5)(c)(iv).

That is, a credit support right under a loan facility would not relate only to the development of land or only to the development of relevant moveable property, but rather would relate to the development as a whole, which includes the development of land and moveable property. The legislative intent is clearly that subparagraphs 820-427A(5)(c)(iii) and 820-427A(5)(c)(iv) should facilitate relevant credit support in this situation.

The Property Council would welcome the opportunity to discuss this submission in more detail. Please contact Matthew Wales, Policy Manager at mwales@propertycouncil.com.au to arrange a meeting.

Yours sincerely

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