INFRASTRUCTURE PARTNERSHIPS AUSTRALIA

4 July 2024

National Tax Liaison Group, Large Business Stewardship Group, and Private Groups members
Australian Taxation Office
Canberra ACT 2000

## SUBMISSION TO THE AUSTRALIAN TAXATION OFFICE ON AMENDMENTS TO THE THIN CAPITALISATION RULES

Infrastructure Partnerships Australia is an independent think tank and executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

Infrastructure Partnerships Australia draws together the public and private sectors in a genuine partnership to debate the policies and priority projects that will build Australia for the opportunities and challenges ahead.

### Background and Content

Infrastructure Partnerships Australia's Tax Policy Taskforce engaged with the Australian Treasury in its development of the Thin Capitalisation legislation through a number of submissions in 2022 and 2023. These submissions can be accessed on our website here.

Please find below a submission in response to the request for targeted stakeholder consultation with National Tax Liaison Group (NTLG), Large Business Stewardship Group (LBSG) and Private Groups Stewardship Group (PGSG) members of the Australian Taxation Office. The submission is split into the three appendices the Office has requested input on.

### Further contact

We appreciate the opportunity to provide this submission and would be happy to discuss it further should you wish.

Infrastructure Partnerships Australia looks forward to further assisting the Australian Taxation Office in this matter. If you require additional detail or information please do not hesitate to contact Mollie Matich, Head of Policy and Research at mollie.matich@infrastructure.org.au.

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## Response to consultation questions

## Appendix A – Restructuring PCG

### 1. What restructuring is being implemented or considered in response to the thin capitalisation rules (in particular, the FRT and TPDT)? Provide specific, real-life examples.

Whilst the proposed amendments to the thin capitalisation rules were first announced in April 2022, it was not until April 2024 that they were legislated by the Federal Parliament. During this period, there was significant uncertainty in the way in which the proposed amendments were to apply. The final substance and form of the measures have changed materially from the time that they were first introduced into Federal Parliament in June 2023.

Faced with this level of uncertainty, taxpayers, particularly those that had a commercial need to raise financing for new transactions or undertake refinancing of existing arrangements during the last two years, whilst wanting to comply with the intent of the new law, had no choice but to take positions with regards to how the measures were anticipated to apply.

Given this, the taskforce appreciates that the ATO has committed to working closely and collaboratively with taxpayers and stakeholders and take a considered approach to companies as they restructure themselves to comply with the reforms. We note the following statement was made by the ATO to the Senate Economics Committee:

> *"we're really mindful that taxpayers will need to manage the transition from the current thin capitalisation regime to the proposed new thin capitalisation regime on passage of the bill, and this may well require restructuring of existing arrangements. We're also mindful that there are some concerns within the stakeholder groups about whether that restructuring might fall foul of the integrity rules, not just in terms of the measure itself but also more generally.*
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> *What I'll say about that is that, as a general principle, the ATO would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law. This is an approach we have taken in the past.[1]"*

It is generally accepted that a "tax benefit" will not be inferred from ordinary commercial dealings simply due to the existence of a tax benefit[2]. The fact that a particular commercial transaction is chosen from a number of possible alternative courses of action because of a tax benefit associated with its adoption does not of

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[1] Mr Ben Kelly, Deputy Commissioner, Australian Taxation Office, Proof Committee Hansard, 31 January 2024, p. 18.
[2] *Commissioner of Taxation v Hart* (2004) 217 CLR 216 at p.227 at [15].

itself trigger the application of the anti-avoidance provision. Simply because a taxpayer pays less tax, if one form of transaction rather than another is chosen, does not mean that Part IVA is enlivened[3].

The taskforce submits that the ATO's compliance approach should be consistent with the application of the general anti-avoidance provision. Where a structure, which is compliant with the previous thin capitalisation regime and commercial in nature, is modified or changed to comply with the new thin capitalisation regime and the new structure adopted is compliant with the new regime and itself is not uncommercial, the act of restructuring should not trigger the application of the integrity rules.

We note that there is precedent for this compliance approach. In PCG 2018/17 - *Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements,* the ATO adopts a commonsense approach to restructuring activities triggered by legislative reform. At paragraphs [10] to [12] the ATO states:

> *10. The character of schemes before and after any change, rather than the fact of change, will generally determine the application of Part IVA. Where a taxpayer has engaged in ordinary commercial dealings before a change and engages in ordinary commercial dealings after the change, the fact that the change preserves a tax benefit will generally have no significance. This is because a tax avoidance purpose will not be inferred from normal business dealings just because a tax benefit is obtained as a result.*
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> *11. For the same reason, the alteration of a contrived scheme to one that is an ordinary dealing (albeit one that results in the obtaining of a tax benefit) would not ordinarily invite an inference that the main purpose of the new dealing is to obtain the benefit. Obviously, if the scheme after the change is in itself contrived, different considerations arise, and schemes that are contrived before and after the change will naturally invite the closest examination.*
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> *12. Where, as a result of the restructure the hybrid mismatch rules will have no application (for example, a deduction/non-inclusion (D/NI) or double deduction (DD) outcome has been eliminated), an Australian tax benefit may be consequently obtained. In such a case, the replacement arrangement would be considered low risk such that the Commissioner would not seek to apply Part IVA where the restructure merely removes the double non-taxation outcome and the arrangement is itself an ordinary commercial dealing or structure without contrived features that would otherwise attract Part IVA.*

Subsequent to the enactment of the final legislation, there has been a lot of detailed reviews undertaken by taxpayers' of their financial arrangements in light of the new law. We are aware of the following changes being contemplated in response to the new law:

- Changes or amendments to the terms of pre-existing conduit financing arrangements to comply with the TPDT, in particular paragraph 820-427C(1)(d). It is our view that pre-existing on-loan arrangements were implemented in the context of a different regulatory environment (i.e. ALDA / Safe Harbour tests). Any amendments to ensure that the TPDT is satisfied for arrangements that are consistent with the policy

[3] *Minerva Financial Group Pty Ltd v Commissioner of Taxation* [2022] FCA 1092 at [60 to 69].

underpinning the TPDT should be regarded by the ATO as being acceptable. Potential amendments to existing on-loan arrangements include, but are not limited to, the following examples:

    - Where the lender has the ability to charge additional amounts with the agreement of the borrower in on-loan agreements, this power being removed from the on-loan documents.
    - Revising on-loan arrangements to remove external foreign currency hedging costs or hedge gains embedded in the on-loan pricing to satisfy the “same terms” requirement in s820-427C(1)(d).
    - Amending the interest rate payable on on-loans from blended rates (for example, a “weighted average cost of debt”) to back to back rates.

- Changes or amendments to third party commercial contractual arrangements that contain terms which prohibit or otherwise restrict the ability for genuine third party debt that is on-lent through conduit financing to be made on the “same terms” under s820-427C(1)(d) should be permitted. Potential amendments to commercial contractual arrangements include, but are not limited to, the following examples:
    - An arrangement which requires third party hedge gains and losses that are attributable to third party debt are to be passed on to the ultimate borrower in conduit financing arrangements. However, passing on hedge gains in the on-loan may not satisfy the “same terms” requirement in s820-427C(1)(d) where a literal interpretation of s820-427C(2)(d) is adopted, nor will passing on foreign exchange hedging costs as they are not costs associated with hedging or managing interest rate risk.
    - An arrangement which restricts the tenor of the debt that may be made in the on-loan.
- Given the prescriptive nature of the TPDT, any modifications to financing arrangements that seek to simplify existing arrangements should be permitted. For example, in the case of a cross staple arrangement which consists of Finance Company (FinCo)[4] borrowing from a third party lenders and lending to Asset Trust, and Asset Trust on-lending to Operating Company/Trust, taxpayers and seeking to remove the loan from Asset Trust to Operating Company/Trust by having Finco lend direct to Operating Company/Trust, which then repays the loan from Asset Trust to Operating Company/Trust, which then repays (partially) the loan from Finco to Asset Trust. Whilst this is not necessarily required to respond to the thin capitalisation rule changes, the thin cap changes are the catalyst for this change which achieve a simpler structure and is consistent with ATO views from its Infrastructure cell about how stapled structures should operate.
- Any arrangements to remove or convert excessive debt that would be otherwise denied under the new thin capitalisation regime should be permitted. For example:
    - Injecting new ordinary equity capital to fully or partially repay existing interest bearing loans from equity investors.
    - Interest bearing loans from equity investors are being converted into interest free loans.
- Any changes made to the security provided to external lenders with respect to genuine third party debt should be permitted. As any changes to the security package would have commercial implications to both the borrower and the lender (either in the form security, cost of debt or size of debt), these changes should be permitted. For example:

[4] In the context of infrastructure, it is common for a special purpose finance company to be used to borrow from external third party lenders (Fin Co) on behalf of a group of entities. The Fin Co will lend the moneys raised to the group as required. The use of a Fin Co permits lenders to lend to one entity within a group.

- Changing the terms and parties providing actual or potential guarantees, securities or other forms of credit support. For example, removal of parent guarantees.
- Refinancing third party debt or otherwise changing the terms of recourse of third party lenders to Australian entities only (i.e. narrowing the security net).
- Refinancing conduit financing or otherwise changing the terms of recourse of third party lenders to limit it to Australian assets that are membership interests in the conduit financer and entities that issue a debt interest that satisfies the conduit financing conditions in s820-427C.
- Divestment of non-Australian assets.

The above restructures generally occur without the physical movement of cash and are typically implemented through payment directions or promissory notes.

### 2. When restructuring in order to satisfy the conduit financing conditions, what are the key issues (for example, how can the above-mentioned issues of margins, weighted costs and swaps be addressed in practice)?

We believe that there are three main types of changes:

1. inter group transactions that do not require third party interactions and approvals (noting investor and/or director approvals may be required to make amendments)
2. changes involving equity investors, and
3. changes that involve consent from third parties or require changes to the arrangements with third parties. The third parties in the context of infrastructure could include the relevant State agency or third party lenders.

The first category can be implemented relatively easily as they are matters broadly internal to the group, e.g. amendments to on-loan arrangements to ensure interest rate and other cost terms are on back to back basis.

The second category includes matters such as amendments to investor loan terms and equity recapitalisations to repay investor loans and/or where changes to internal arrangements require investor consent.

For certain taxpayers with one or a small group of similar investors, this is likely to be something that can be achieved more quickly than where the investor group is large or comprises different investor types (e.g. Australian superannuation funds versus multinational groups). These types of changes typically require external legal and tax advice to be sought for each party and consensus to be reached on the changes to be made taking into account the circumstances of each investor.

The final category includes matters such as:

- An investor that holds a 20 per cent or more interest in a taxpayer which has provided a parent company guarantee to the taxpayer in respect of another party's performance of a commercial contract. Such a guarantee may be completely commercial with similar guarantees provided by parties that do not hold a 20 per cent or more interest the taxpayer.

- Restructures that require interaction with the market – i.e. if a FinCo has entered into a cross currency interest rate swap, such swap may need to be terminated and re-entered into as separate currency (FX) swap and interest rate swap.
- Changes to on-loan arrangements which require third party consent. Third party financing arrangements that are based on a security package typically have strict terms, conditions and consent requirements for any proposed changes to on-loan arrangements. Further, infrastructure businesses usually have extensive contractual arrangements with the State which govern the rights and obligations of the parties. These arrangements may require consent to be given by the State and external financiers for any changes to on-loan arrangements.

Changes in the third category are likely to have real cost and commercial consequences for the taxpayer and require protracted negotiation with counterparties.

### 3. What type of risk-based metrics, factors or zones could the ATO consider adopting to rate restructures in response to the thin capitalisation rules?

The policy taskforce respectfully submits that restructures that have the following features should be regarded as low risk and the ATO should confirm that it will not apply compliance resources to these structures:

- The restructure does not result in an increase to the amount of annual debt deductions under s820-40 for the taxpayer or the amount of debt interest issued by the taxpayer.
- Arrangements under which on-loans or other documents are amended to enable the conduit financing provisions to be satisfied for genuine third party debt, including debt that is in on-lent on the same economic terms.
- Arrangements that seek to redefine the security structures to ensure that the recourse requirements of sections 820-49 and 820-427A are met.
- Arrangements which replace debt with equity.
- The original arrangement prior to the restructure would not have attracted the application of Part IVA and the replacement arrangement on a stand-alone basis would not attract the application of Part IVA. By stand-alone basis we mean the arrangement as viewed without regard to the original arrangement or the restructuring steps.
- The restructure and replacement arrangement are effected in a straightforward and commercial manner reflecting arm's length conditions.

As stated above, there was significant uncertainty and change in the final substance and form of the new measures in the two year period from the time that the rules were first announced to when they were finally enacted in April 2024.

Further, as the new law was enacted 10 months after the commencement of the first income year to which the new rules apply and final ATO guidance is unlikely to available for many more months, the taskforce submits that it is fair and equitable for the ATO to not apply compliance resources to restructures that are documented to apply from 1 July 2023, notwithstanding that the documentation is completed after this date.

The taskforce respectfully submits that this approach be undertaken by the ATO for restructures that occur before the end of 12 months after the publication of the final PCG. The request for 12 months is reflective of time to interpret the ATO guidance, develop an appropriate response and implement the restructures which may require third party and/or investor consent.

### 4. What restructures are currently being implemented or considered in response to the DDCR? How do those restructures not attract the application of the DDCR? Please provide specific examples including whether the prescribed transactions giving rise to debt deductions covered by subsections 820-423A(2) or (5) are limited to historical or prospective transactions.

At this time, the focus has been on understanding whether any loans are caught by the DDCR ("non-compliant loans" for the purposes of this submission), and current uncertainty around tracing and piecing together what happened many years ago.

Once a non-compliant loan is identified, that loan will generally remain a non-compliant loan until it is repaid (and not repaid from another related party borrowing or related party borrowing sourced from third party borrowing).

The taskforce respectfully submits that the ATO should provide written guidance that the repayment of non-compliant loans does not trigger the application of section 820-423D or another anti-avoidance provision (even if non-compliant loans are repaid in priority to other loans held by the taxpayer).

### 5. In what circumstances would stakeholders consider it necessary to replace related party debt attracting the application of the DDCR with third party debt? Provide specific examples, including where third party debt arrangements directly or indirectly fund transactions prescribed by subsections 820-423A(2) and (5).

The use of third party debt does not trigger the application of the DDCR, even if all other conditions of section 820-423A(2) and (5) are satisfied. Similarly, if third party debt replaces non-compliant related party debt, the requirements of section 820-423A(2) and (5) are not satisfied.

It is submitted that in all circumstances where third party debt is used to replace related party debt, irrespective of whether an election is made to apply the third party debt test, this should not attract the application of the integrity or anti-avoidance provisions (other than in extreme convoluted and contrived circumstances). This is on the basis that had third party debt been used at inception, this would not have triggered the application of the DDCR.

For example, shareholder loans may have been put in place to permit cash extraction. The funds from those shareholder loans may have been used for purposes which make it a non-compliant loan (e.g. buy trading stock or depreciating assets from an associate pair on arm's length terms).

At the time the shareholder loans were issued, third party debt may not have been readily available at a good price or able to be raised in the time available. After a period of time, third party debt may be able to be raised at a more cost effective price than the shareholder loans or third party debt may provide more diversified funding for the business. In these circumstances, it may be commercially desirable to enter into third party debt to repay the shareholder loans.

However, it is unlikely that infrastructure taxpayers would be able to in practice rely on the third party debt exemption for the DDCR in all circumstances. Typically, funds are raised by a special purpose FinCo. FinCo then on-lends the third party debt within a group of entities, converting the debt to related party debt. Under the DDCR, although the funds are sourced from a third party as it is on-lent through the group, the on-lent portion is inappropriately regarded as related party debt. This may trigger the application of the DDCR if the remaining conditions of sections 820-423A(2) or (5) are satisfied. Even if a related party debt is refinanced by a third party debt, the use of a FinCo would effectively mean that the on-lent portion is regarded as related party debt. This outcome is modified only where the TPDT is elected (sections 820-423A(2)(f) and 820-423(5)(f)).

The taskforce respectfully submits that the above outcome is inappropriate. The DDCR is intended to apply to related party "debt creation" and should not apply to third party debt on-lent through groups of entities (typically on back to back terms), irrespective of whether an election to apply the third party debt test is made. Given the extremely prescriptive nature of the TPDT, it may be the case that many entities will not elect the TPDT including due to technical breaches of the requirements.

The taskforce respectfully submits that the ATO should adopt a compliance approach that would regard certain arrangements as being "low" risk, from a DDCR perspective, where they involve third party debt that has been on-lent on back to back terms – as opposed to related party debt (which is the real focus of the DDCR).

### 6. What type of risk-based guidance and, where relevant, risk factors or zones do stakeholders consider may assist in evaluating restructures in response to the DDCR?

The taskforce respectfully submits that the ATO should not apply compliance resources to restructures that involve repaying or refinancing non-compliant loans that were entered into before the enactment of the thin capitalisation amendments and which occur before the end of 12 months after the publication of the final PCG. This includes where a taxpayer decides to repay non-compliant loans in preference to repaying compliant loans.

We also note the comment in paragraph 1.43 of the Supplementary Explanatory Memorandum accompanying the legislation, following inclusion of a related party debt condition in the DDCR, to the effect that the anti-avoidance rule in section 820-423D is concerned with "*[s]chemes that seek to exploit the related party debt deduction condition to artificially locate or 'debt-dump' third-party debt in Australia*". We assume that this concern would more naturally apply to a multinational group that has existing third party debt in a foreign jurisdiction, and which chooses to restructure global debt arrangements in response to the DDCR so that a related party debt (indirectly funded by third party debt in a foreign jurisdiction) is replaced with a direct third party debt located in Australia.

However, typical debt arrangements in the infrastructure sector are not analogous to such circumstances, nor are such arrangements properly characterised as “debt dumping”. Rather, the existence of an arm’s length third party debt is a common and commercially justified feature of arrangements in the infrastructure sector. There typically is no alternative jurisdiction for debt arrangements in this context. Rather, such arrangements may inappropriately attract the operation of the DDCR as a result of the absence of a conduit financing exclusion in the DDCR (as mentioned in previous responses above). Accordingly, even if the ATO proposes to apply section 820-423D to certain debt restructuring in response to the DDCR, we submit that any restructuring of such arrangements in the infrastructure sector should generally not attract the anti-avoidance rule, and the ATO should therefore clarify in its risk-based guidance that it would not apply compliance resources to such restructuring.

### 7. What records do stakeholders have available to trace the use of debt and evaluate whether debt deductions arise from a historical transaction covered by subsections 820-423A(2) or (5)?

Different taxpayers have different records about the past. For example, where an entity has been acquired, the purchaser may have acquired a much smaller set of records, and a business with higher staff/director turnover would less likely be able to piece together details of prior transactions. Further, under law, there is generally no need to retain records beyond 7 years and the legal department of certain organisations require all documents older than this to be automatically destroyed.

Under the Tax Act, record keeping obligations are clearly defined but generally records are not required to be kept beyond the period of review of five years[5]. Further the tax law up to now has not required taxpayers to retain records around DDCR matters, and it may be unreasonable to expect taxpayers to create those records today to the standards expected to be created for new debts created after the enactment of the DDCR and issue of ATO guidance. Indeed, it may be impossible for many taxpayers to now trace the historical flow of funds between entities in a group and identify the specific purposes for which the funds were used in each leg of the funds flow. This is particularly the case where funds were transferred between entities in an income tax consolidated group where transactions between members of the group are ignored for income tax purposes.

Taking into account these matters, the taskforce respectfully submits that:

- Any debts created prior to the announcement of the DDCR are deemed to not be non-compliant loans. We encourage the ATO to not apply compliance resources to these loans.
- For debts created in the period post the announcement of the DDCR, a taxpayer need only establish on a reasonable basis that the dominant purpose of the funds were not used for a purpose that makes a loan a bad loan over a period of six months. There would not be an obligation to undertake detailed tracing of funds to identify use within that six-month period. For example:

[5] For example, see sections 262A of the ITAA 1936, Division 121 of the ITAA 1997, Division 28 of the ITAA 1997, Division 900 of the ITAA 1997.

  - if a company borrowed $100 from a new shareholder loan and it remained in a bank account for more than six months, it is deemed to not be non-compliant loan
  - if a company borrowed $100 from a new shareholder loan within six months acquired a new subsidiary for $150 and the dominant purpose of the borrowing was communicated and/or documented to be for acquisitions from a third party, then the $100 shareholder loan would be considered not to be a non-compliant loan, or
  - where a company borrowed $100 from a third party and those funds were on-lent to other entities in the group for the dominant purpose of general working capital and were used as such. After applying the rules in the *Corporations Act 2001* and constituent documents, as well as company policy regarding dividends, the company distributed $5 dividend to shareholders within six months.
- Inter-group payables are not considered to be non-compliant loans if created or increased prior to the issuance of the final ATO PCG.
- Any interest capitalised prior to the issuance of the final ATO PCG follows the classification of the underlying loan.

### 8. What apportionment methodologies do stakeholders consider appropriate for 'mixed-use' debt and why?

The taskforce respectfully submits that as the DDCR is an anti-avoidance rule, with a broader general anti-avoidance rule tacked on, with a broad application base, the base presumption needs to be that the DDCR is presumed not to be breached on normal commercial transactions and activities, but catches specific uses of related party debt that is not permissible. It then follows that mixing funds into a general bank account in itself does not result in the application of the DDCR and any reasonable approach to apportion or trace the use of funds should be permitted. One possible permissible approach is set out below.

Firstly, if a taxpayer has maintained specific records, then that should be given priority (even if the accounts are a breakdown of a single bank account).

Secondly, if the purpose of a loan is disclosed in the borrowing documents or board/investor meeting minutes, then that purpose should be respected unless it is clear the loan has been used for other purposes.

Thirdly, in the absence of the above, given the DDCR is a specific anti-avoidance provision with a further catch all anti-avoidance provision, the taskforce believes that the presumption should be a good use unless it is clear the use is non-compliant use. There should also be a period of six months from the loan drawdown date to undertake analysis for the use for DDCR purposes.

For example, if there is $100 raised from the issuance of a new shareholder loan and net business revenue of $75 earned and both of these amounts are deposited into a bank account that previously had a nil balance:

- If within six months of the loan drawdown a $50 dividend is paid and the residual remains as cash at bank, then the $50 should be presumed to have to been paid only out of net business revenue and none of the shareholder loan is a non-compliant loan under the DDCR.
  - If subsequently a further $80 dividend is paid within six months of the loan drawdown, then the first $25 of this dividend is presumed to have been paid out of net business revenue and $55 is

presumed to have been paid out of the shareholder loan proceeds and therefore a potentially non compliant loan under the DDCR.

   - If however $80 was used for purposes that are not deemed bad within six months of the loan drawdown (i.e. purchase of trading stock from third parties, paying business expenses to third parties, acquiring new shares), then those funds are deemed to have been paid out of the shareholder loan proceeds.

- The above would mean that a taxpayer merely needs to in the six months after the loan drawdown either:
   - identify $100 of good uses for the funds, or
   - ensure that there is less than $75 of bad uses for the funds

  to treat the DDCR as not applying in respect of that shareholder loan drawdown.

In the event that a taxpayer has blatantly manipulated the principles above beyond normal commercial dealings and attempted to hide a borrowing which the DDCR intends to capture, then the catch all anti-avoidance provision of the DDCR remains available to the Commissioner to utilise.

## Appendix B – Third Party Debt Test

12. Do you have examples of debt interests you consider are intended to satisfy the third party debt conditions in subsection 820-427A(3), but which raise practical or interpretative issues about whether a particular condition is satisfied 'in relation to [the relevant] income year'?

Where third party debt is provided to an Australian entity and the quantum/terms of the debt are not enhanced by the provision of non-obligor associate entity credit support or non-Australian assets, the policy is that the TPDT should be available (See for example the commentary in Para 2.99 of the EM). The issue that arises is that the core concepts including obligor group, recourse, and Australian assets are broad and undefined terms and any failure of a debt condition effectively excludes the TPDT. Hence the interpretation of those terms to be consistent with the TPDT being available in accordance with the policy makes sense. We have included an example at Appendix A to illustrate some of the issues raised.

13. In responding to Question 12, you may wish to consider:

a. Will an entity satisfy paragraph 820-427A(3)(a) in relation to an income year if the entity issued the debt interest in an earlier income year (and assuming the other requirements of paragraph 820-427A(3)(a) are satisfied)?

This test can only be satisfied if the debt was originally issued to an entity that was not an associate entity of the issuer under the definition in s820-427D at the time it was issued. If the entity that originally held the debt later became an associate entity of the issuer, this in of itself should not prevent this condition from being satisfied, as this would be dealt with by the condition in paragraph 820-427A(3)(b).

This condition is able to be satisfied in years following the issue of the debt by looking back at circumstances of the original issuance of the debt and applying the definition in s820-427D to those circumstances. Limiting the ability to satisfy this condition (and as such, to have a debt that satisfies all of the third party debt conditions) to the year the debt is issued only would not be consistent with the intention of the third party debt test.

b. Are the conditions in paragraphs 820-427A(3)(c) and (d) tested continuously throughout the relevant income year?

We refer to our submission under Question 3 to permit certain restructures to apply from 1 July 2023.

Our submission in relation to this question is in respect of the period post permitted restructures (i.e. post 12 months after the publication of the final PCG).

For a debt interest to satisfy condition (c) in relation to an income year, a literal reading might be thought to imply that this test must be satisfied at all times during the year where the debt was in existence.

The provisions do not appear to contemplate breaking the year into periods in which these conditions can be satisfied. This means, for example, that if a debt is on issue for the whole of the 2024 income year, and was amended in April 2024 to limit recourse to permitted assets only, no debt deductions would be included in the third party debt limit for the 2024 year in relation to that debt. Essentially, such a reading would mean that this condition cannot be met until the year following the amendments being made.

We believe that it is possible to read the provisions such that the debt deductions can be apportioned.

An entity's third party earnings limit for an income year is the ***sum of each debt deduction*** of the entity that is attributable to a debt interest issued by the entity that satisfies the third party debt conditions ***in relation*** to an income year.

The words "in relation" to implies a connection between the satisfaction of the third party debt test and the income year, with the level of acceptable connection determined by the context of the provision themselves.

In the context of the provisions, there is nothing to imply that the third party debt test is required to be satisfied at all times during the income year. The context of the third party debt test is to "*operate 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'*".

In its context, the word "that is attributable" should be read "to the extent" or 'explainable by". In other words, each of the entity's debt deductions that can be explained by a debt interest that satisfies the third party debt test.

If the legislature intended "at all times" - these words could have easily been used. Legislature could have also used the words "at any time" as well if it wanted to.

The taskforce respectfully submits that accordingly, there is no policy reason to limit debt deductions attributable to part of income year if the third party debt conditions are satisfied for that part of the year.

Similar to paragraph (a), we consider that this condition d) is generally satisfied by looking back at the original use of the proceeds from issuing the debt interest. If it were necessary to consider whether those proceeds continue to be used to fund the entity's commercial activities in connection with Australia over the course of the entire current income year, then this presents significant difficulties in tracing.

In some cases, the use of funds will not change over the period a debt is on issue, so if this condition is satisfied having regard to the original use of funds in the year of issue, it will continue to be satisfied in subsequent years.

We have also encountered circumstances where the proceeds of issuing a debt interest have been temporarily used for a purpose that does not meet this condition before being redeployed to another use. For example, an Australian entity has borrowed money from an Australian bank for use within its business, however it has temporarily placed this on deposit with its foreign parent where it generates a higher interest return then the rate on the loan. Guidance indicating that such temporary use of proceeds such as this is able to be disregarded when considering this condition would be welcome.

### c. Does an entity need to be an Australian entity throughout the relevant income year in order to satisfy paragraph 820-427A(3)(c) in relation to the income year?

Where a debt is issued part way through an income year, this condition (c) would in our view only need to be satisfied at all times that the debt is on issue. We also believe that an apportionment approach be adopted if an entity is not an Australian entity for the whole year.

### d. What is the appropriate operation of the third party debt conditions where a debt interest comes into existence (or is satisfied) part way through an income year?

With regards to arrangements that come into existence during an income year, in our view these conditions should only be applied to the period the debt interest is in existence.

For debt interests that satisfy the third party debt conditions part way through an income year, we refer to our submission under Question 3 to permit certain restructures to apply from 1 July 2023.

### 15. What, in your view, constitutes ‘recourse’ for the purpose of paragraph 820-427A(3)(c)?

The concept of “recourse” or “recourse for payment of the debt” is not defined and there is limited discussion of its meaning in the Explanatory Memorandum. According to the Encyclopaedic Australian Legal Dictionary, recourse is defined as “the right to claim against a debtor or guarantor where a default has occurred, or against a drawer or an endorser in respect of a dishonoured bill of exchange.”

The Macquarie Dictionary (Online Ed.) defines “recourse” in the context of commerce as:

> *“the right to resort to a person for pecuniary compensation. An endorsement without recourse is one by which a payee or holder of a negotiable instrument, by writing ‘without recourse’ with their name, merely transfers the instrument without assuming any liability upon it.”*

Based on the drafting in the legislation, it is the taskforce’s view that the use of the word “recourse” in both paragraph 820-49(1)(b) and in paragraph 820-427A(3)(c) is intended to be limited to the “recourse” permitted by the contractual arrangements that support the issuance of the relevant debt interest being tested (from both the creditor and debtor’s perspective).

That is, for the purposes of:

- Determining obligor group: A creditor’s recourse for payment of a debt interest is limited to assets held directly by one or more other entities, and

- **Determining an Australian asset:** A creditor's recourse for payment of a debt interest is limited to assets held directly by members of an obligor group.

The dictionary definition is consistent with the meaning one would arrive at if the term "recourse" were to be analysed using the modern approach to statutory construction. The modern approach to statutory interpretation looks at the purpose of Parliament to ascertain the mischief to be remedied by statute. In *CIC Insurance Ltd v Bankstown Football Club Ltd*[6], Brennan CJ, Dawson, Toohey and Gummow JJ observed that:

> *". . . the modern approach to statutory interpretation (a) insists that the context be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses 'context' in its widest sense to include such things as the existing state of the law and the mischief which, by legitimate means such as [reference to reports of law reform bodies], one may discern the statute was intended to remedy."*[7]

The modern approach to statutory context is to be considered from the beginning of the interpretive process, not merely when the ambiguity has been observed. The second aspect of the modern approach is that 'context' has a wide meaning, including the 'mischief' that is discoverable by the legitimate use of extrinsic material.

The purpose of the third party debt test is *"to operate effectively as a credit assessment test, in which in an independent commercial lender determines the level and structure of the debt finance it is prepared to provide an entity"*[8]. The term "recourse" must be interpreted within the context of perceived mischief sought to be remedied.

When viewed in the context of the legislative provisions, an entity provides recourse to a creditor in relation to its assets (in the context of the various provisions of the third party debt test). This implies that a creditor is entitled to recover a sum of money against an entity's assets; nothing more than that. Namely to determine the amount of assets of the borrower or another entity that are available to satisfy the lender in the event of default by the borrower. The ordinary meaning of the word recourse implies that the legislature only intended to capture arrangements where there is a direct right to pecuniary compensation and not through other indirect arrangements.

It is noted that very limited case law exists regarding the definition of the phrase "recourse" in a commercial context to be able to arrive at a definitive interpretation. At a broad level, within the context of contract law, it has been said that[9]:

> *"One has "recourse" to a security by resorting to it for the purpose of gaining some benefit from it"*

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[6] (1997) 187 CLR 384.
[7] (1997) 187 CLR 384 at [408].
[8] Paragraph 2.90 of the Explanatory Memorandum.
[9] *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd (in Liq)* [1978] HCA 45 at 23.

*National Australia Bank Limited v Human Group Pty Ltd*[10] gives further weight to this interpretation, confirming that "recourse" is an ability to resort directly to an asset for a benefit, but does not imply control or ownership over that asset. This case concerned the ability of National Australia Bank (NAB) to seek a *Mareva injunction* over the assets of a third defendant in that case – ACN – in order to recover funds that were allegedly fraudulently stolen from NAB by the first defendant. Whilst the focus of that case centred around whether it was appropriate for the first defendant to have recourse against the assets of ACN for the purposes of supporting the first defendant's ordinarily living expenses, the Court held that:

> *"the assets to which Ms Rosamond wishes to have recourse are held by a third party and are, thus, not her own assets to use as she pleases"*[11]

This implies that the common definition of recourse is limited to direct compensation as opposed to indirect or quasi-control.

Further case law suggests that for debts, "full recourse" suggests unfettered recourse in respect of a party and their assets, contrasted with "limited recourse" under which some restrictions apply to a party's ability to resort to a party in receipt of benefits. Some further judgements do broadly assist in ascertaining a general judicial approach in relation to "recourse".

The judgement in *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd*[12] held that in a general sense, recourse is ordinarily confined to contractual terms, and that recourse to items outside of this requires consideration of whether recourse to things external to the contract was a commercial intention of the parties. While this does not specifically deal with recourse to debt, it is still instructive that recourse to a party under contract will generally mean direct recourse unless there is express intention for it to extend to external items.

A view that a creditor could be seen as having recourse for payment of a debt to the assets of every entity that is liable to make a payment to the debtor (i.e. commercial counterparties) as, ultimately, the creditor can take control of all of the assets of the debtor and thereby indirectly access the assets of such entities by demanding payment, commencing legal action and eventually taking control of the counterparty (i.e. through receivership) must be rejected for the following reasons:

1. Such a broad interpretation would seem to be unintended. For example, it could be argued that for a retailer that supplies on credit terms, that the retailer could have access to the assets of its debtors by demanding payment from its debtors (and taking subsequent action). Such a view would mean that the third party debt test would be unavailable to the vast majority of the entities operating in Australia; which is both absurd and in-coherent.

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[10] (No 2) [2020] NSWSC 1900.
[11] (No 2) [2020] NSWSC 1900, 167.
[12] [2015] HCA 37, 47-51.

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2. From a practical and commercial perspective – unless a relevant arrangement provides support to the lender, to enable that lender to provide credit, those assets would not be regarded by the lender. The assets belonging to commercial counterparties are generally not regarded by lenders for credit assessment purposes; it is the assets that are directly available to the lender from the borrower that would form the basis of their credit assessment. The assets of any commercial counterparty exist on the same footing for both secured and unsecured lenders.

3. The relevant recourse against the assets of the commercial counterparties is so inherently contingent that it cannot be said to be recourse at all. A creditor's rights against the assets of a commercial counterparty of the borrower can be defeated by a number of circumstances, the simplest of which is payment by the commercial counterparty or the performance of some action.

The limited discussion on recourse in the Explanatory Memorandum relates to the concept of "obligor group" section 820-49:

> "*The mutual election obligation was limited to only the associate entities (of the relevant entity) in the obligor group (a common commercial concept). This removed the unintended consequence of requiring a wide range of unrelated entities to elect to apply the third-party debt test.*"

Syndicated facility agreements and associated financing documents often refer to "obligors" and the "obligor group". Relevantly, under syndicated facility agreements and associated financing documents, "obligors" are parties to those agreements as entities that form part of the 'security net' and can be primarily liable for a debt or can be a guarantor.

Independent commercial lenders, in their credit assessment of how much debt finance they are prepared to provide an entity, will take into account the assets of the borrower and the obligors, i.e. entities in the security net. As part of this assessment, lenders will often require certain information to be provided on the borrower and the obligors but generally not beyond this, i.e. they would typically not require information on every entity that is liable to make a payment to the borrower.

Our view, which we consider is supported by the explanatory memorandum and legislative intent, is that the phrase "recourse for payment of the debt" is to be interpreted in line with the common commercial concept of an "obligor group" as it is used in such agreements. In addition, where an entity is a party to an agreement referred to in a debt agreement that provides recourse to the assets of that entity (e.g. a parent guarantee) we consider that they would also be obligors as the creditor has recourse to the assets of that entity. We consider this to be recourse, and applicable to the concept of recourse used in subsection 820-427A(3)(c) and section 820-49.

We note that paragraphs 820-427A(5)(a)(ii) and (b) refer to direct and indirect recourse, whereas subsection 820-427A(3)(c) and section 820-49 make no mention of recourse being direct or indirect. Applying the common law principle for construing legislation, *expressio unius est exclusio alterius* (the expression of one is the exclusion of others), the omission of the word "indirect" in subsection 820-427A(3)(c) and section 820-49 means that recourse in these provisions is not intended to include indirect recourse. As such, we consider that the concept of recourse in subsection 820-427A(5) is broader than that used in subsection 820-427A(3)(c) and section 820-49 which relates to direct recourse only, as set out above.

Specifically in an infrastructure context, we refer to the example of a greenfield renewable asset in Appendix A and our submissions regarding the proper interpretation of recourse for the purposes of section 820-49 and section 820-427A(3) and direct or indirect recourse for the purposes of section 820-427A(5).

### 16. Are there any legal, commercial or tax concepts that could be relied on to inform the meaning of 'recourse' in the context of paragraph 820-427A(3)(c)?

Refer to Question 15 above.

### 17. Do you have examples of arrangements which raise practical or interpretative issues about whether paragraph 820-427A(3)(c) 'recourse' is satisfied?

Please see the example in Appendix A.

### 18A. What, if any, distinction should be drawn between the interpretation of 'recourse' in section 820-49, paragraph 820-427A(3)(c) and subsection 820-427A(5)?

Section 820-49 and 820-427A(3)(c) relates to direct recourse rights held by the creditor against assets of the debtor or parties in the obligor group.

Recourse in s820-49 and in s820-427A(3)(c) excludes indirect recourse.

In contrast, the wording in section 820-427A(5)(a)(i) and (ii) dealing with rights that are credit support, explicitly refer to recourse that arises directly or indirectly and, on this basis, we think involves a broader range of parties to which a lender may have recourse than contemplated in the previous two paragraphs.

Where a third party bank (LC bank) provides a letter of credit to a borrower to support the performance of a counterparty to the borrower (e.g. offtaker, service provider) then, depending on the specific legal arrangements the borrower might be argued to have some form of indirect recourse to the LC bank/counterparty assets and as a result risks that those parties could become an obligor entity.

These matters are further considered in the context of a specific example of a greenfields renewable asset development in Appendix A.

If indirect recourse extends to 820-427A(3)(c) then that LC bank has non-Australian assets (e.g. a foreign bank or an Aust bank with offshore business assets) and hence the risk is that the borrower has recourse to non-Australian assets of the LC bank and accordingly this right is a precluded right for the purposes of section 820-427(3)(c)?

This issue could extend to any party who provides performance guarantees of a counterparty to the borrower. “Recourse” must therefore be intended to have a much narrower definition.

Again, these matters are further considered in the context of a specific example of a greenfields renewable asset development in Appendix A.

### 18B. What, in your view, constitutes ‘minor or insignificant’ for the purpose of paragraph 820-427A(3)(c)?

The Explanatory Memorandum refers to this carve-out being directed at avoiding the section being contravened for inadvertent and superficial reasons. Our view is that interpretation of minor or insignificant is intended to be in reference to the lending decision being made to an entity by an independent third party commercial lender.

From an assessment of the use of minor and insignificant in other legal contexts, it appears that the terms are not objective terms but are instead a test of relative values. A relative test is critical in this context as it enables the test to be appropriately applied to businesses of different size. In paragraph 820-427A(3)(c), we consider that these words are intended to be read as minor or insignificant relative to the business’ operations in the context of an independent commercial lender’s decision in providing finance to an entity.

The interpretation provides that if the lending would still have occurred but for the inclusion of the non-permitted assets (i.e. the minor or insignificant assets), then those assets should not be significant to the transaction. This is in the context of the third party lender’s perspective, whereby if the lender adopts the view that the non-permitted assets are irrelevant, they will elect to provide the debt with the assumption that the borrower can sustain the borrowing without foreign assets of a foreign parent company’s guarantee.

The wording of the Explanatory Memoranda appears to support this view, with the following quotes being phrased from the lender’s perspective:

> *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.*
>
> *1.29 The holder of the debt interest being tested under the third party debt test (referred to in this document as the ‘tested debt interest’) can now have recourse to the following kinds of assets (disregarding recourse to minor and insignificant assets)...*
>
> *1.45 ... These conditions are intended to ensure that an entity’s debt deductions are only allowed where they are attributable genuine third party debt that is borrowed against Australian assets and is used to fund Australian operations...*

From a review of the legislative materials (and the limited guidance provided within), we consider that the intent of the policy is to facilitate only genuine third party commercial transactions and the assets that a third party lender would concern themselves with in its ordinary course of providing finance to an entity.

We acknowledge the ATO's preliminary view in the consultation paper that this is only intended to cover assets of minimal or nominal value, however as set out above, we do not believe this is in line with the context or intention of the provisions. We do note, however, that the inclusion of a safe harbour in the form of a bright line test (for example, a fixed percentage (say, five per cent) of total assets) under which taxpayers do not need to undertake further analysis which would otherwise be required may assist with reducing compliance costs. We consider this would be appropriate for a PCG or similar to help taxpayers identify lower risk arrangements.

19. Do you have examples of arrangements which raise practical or interpretative issues about whether the paragraph 820-427A(3)(c) 'minor or insignificant' exception is satisfied? What types of assets, and values of assets, are giving rise to uncertainty? Provide specific examples of arrangements.

Refer to Question 18B above.

20A. Do you consider the 'minor or insignificant' exception in paragraph 820-427A(3)(c) relevant to subsection 820-427A(4)?

Yes, if there are minor or insignificant foreign assets – those assets are disregarded and not covered by 820-427A(4). Hence the lender only has recourse to Australian assets and satisfies the requirements in 820-427A(3)(c)(i).

20B. What types of assets are giving rise to uncertainty? Provide specific examples of arrangements.

Refer to Question 18B above.

21. What, in your view, should or should not constitute 'Australian assets' for the purpose of paragraph 820-427A(3)(c)?

The concept of Australian assets is critical to ensuring the effective operation of the third party debt test. There are number of different approaches that can be taken for this issue – for example, distinguishing between tangible and intangible assets, or dealing with assets by class, or by location. In our view, however, none of these approaches is appropriate to ensure the intention of the legislature in including this condition in the third party debt test ids met.

The Explanatory Memorandum makes the following comments on the concept of Australian Assets:

> *2.98 'Australian assets" are 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 existing concept of Australian assets in section 820-37 may also be instructive. This includes, for an Australian entity

> *"all of the assets of the entity other than:*
>
> *any assets attributable to the entity's *overseas permanent establishments; or*
>
> *any *debt interests held by the entity, to the extent to which any value of the interests is all or a part of the *controlled foreign entity debt of the entity; or*
>
> *any *equity interests or debt interests held by the entity, to the extent to which any value of the interests is all or a part of the *controlled foreign entity equity of the entity; ..."*

The third party debt test is intended to be "narrow, to accommodate only genuine commercial arrangements relating only to Australian business operations". This achieved through two conditions – paragraph 820-427A(3)(c) limitation on recourse to Australian assets (other than minor or insignificant assets) and paragraph 820-427A(3) (d) requirement to use the proceeds to fund commercial activities in connection with Australia. As such, it is important that these two tests complement each other – that is, Australian assets should comprise those that are part of the commercial activities in connection with Australia.

We have provided our views on commercial activities in connection with Australia below. Having regard to this, and the existing concept of Australian assets in s820-37, we consider that Australian assets should comprise all assets of the entity (which must be an Australian entity due to the condition in paragraph 820-427A(3)(e) other than:

> *assets used to carry on a business through an overseas permanent establishment*
>
> *controlled foreign entity equity and*
>
> *controlled foreign entity debt.*

### 22. What legal and commercial definitions may inform the term 'Australian assets' in paragraph 820-427A(3)(c)?

Refer to Question 21 above.

### 23. What connection must tangible assets have to Australia in order to be within the scope of 'Australian assets'?

Refer to Question 21 above.

### 24A. How should 'Australian assets' apply to different classes of assets?

Refer to Question 21 above.

### 24B. Provide specific examples where the application of this requirement in paragraph 820-427A(3)(d) to use the proceeds of a debt interest is unclear.

The requirement that the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia is a complex text that has multiple limbs that need to be broken down.

We note at the outset that the concept of "commercial activities in connection with Australia" is taken from the former arm's length debt test. Paragraphs 43 to 50 of TR 2020/4 provide the ATO's views of this concept in that context. Some useful principles relating to the definition of the Australian business (which includes the entity's commercial activities in connection with Australia and then goes on to carve out various amounts, in the same way as 820-427A(3)(d)) include:

- For an inward investing entity that is a foreign entity, the Australian business will comprise its permanent establishments in Australia as well as any other assets that are held for the purposes of producing the entity's Australian assessable income.
- For an outward investing entity, the Australian business comprises all the entity's commercial activities in connection with Australia other than any business carried on, at or through its overseas permanent establishments.
- For an outward investing entity, the Australian business will include activities that give rise to foreign source income where these activities do not give rise to a foreign permanent establishment.

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

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

### 28. Provide examples of arrangements which raise practical or interpretative issues about whether paragraph 820-427A(2)(a) is satisfied.

We believe that the interpretation of section 820-427A(2)(a) and (b) in relation to interest rate hedging arrangements, needs to comprehensively deal with the treatment of hedge gains and losses on interest rate swaps and cross currency interest rate swaps, including debt deduction analysis, and the treatment of gains and losses on the novation/termination/variation of such swaps. The netting of swap gains and losses is very common and needs to be addressed. Further, the payment of amounts as between associate entities in the context of passing through swap gains and swap losses in conduit back to back arrangements needs to be clarified. Please refer to Appendix A for further detail.

## Appendix C – Interaction between Thin Capitalisation and Transfer Pricing Rules

In the context of the amendments made to Section 815-140 of the 1997 Tax Act as part of the entering into law of the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share -Integrity and Transparency) Act 2024 (the Act) and two recent (March 2024) cases dealing with the Tax implications of cross-border financing/debt arrangements ie. *Mylan Australia Holding Pty Limited v The Commissioner of Taxation (No. 2) (2024) FCA 253* (Mylan Case) and *Singapore Telecom Australia Investments Pty Ltd v The Commissioner of Taxation (2024) FCA FC 29*, we respectfully submit that the ATO should proceed carefully and sensitively, as well as consult extensively, with respect to proposed guidelines on the arm's length debt amount, arm's length conditions and related matters.

Briefly, pursuant to the recent amendments to Section 815-140, the modification therein no longer applies to a "general class investor" amongst others, that has made a choice to use the Third-Party Debt Test in the Thin Capitalisation Rules. Accordingly, Section 815-115 in the Transfer Pricing Rules can potentially apply to deem a transfer pricing benefit arising from a non-arm's length debt amount related to cross-border financing ie the arm's length rate of interest is effectively applied to the 'arm's length debt amount' which maybe different to the debt interest actually issued by the relevant taxpayer/entity.

While the ATO maybe looking to refresh and update its previous Practical Compliance Guideline, PCG 2017/4 dealing with various risk profiles, including indicators, factors and metrics to consider/evaluate, associated with cross-border related party financing arrangements, we believe it is critical to factor in various of the considerations, views and guidance particularly provided by Button J of the Federal Court in the Mylan Case (20 March 2024). Most importantly, because the Mylan Case dealt with in part the relationship between the applicable Thin Capitalisation Safe Harbours and Part IVA, including the commerciality of debt funding over equity funding, as well as other issues, we believe the Mylan Case and decision provides important guidance on intragroup debt arrangements for global groups and in this case a global acquisition.

Further, it is noteworthy that the Commissioner initially approached this case on the basis of the Transfer Pricing Rules in addition to Part IVA, and thus various overlapping issues were considered in the course of the hearing of the Mylan Case.

By way of background, it is well understood that the Mylan Case dealt with very specific facts involving a 'push down' of group debt to Australian related party entities following a global acquisition by the Mylan Group, a listed US pharmaceutical company. In October 2007 the Mylan Group acquired the Global Generics Pharmaceutical business of Merck (Merck Generics).

Although it is noted that the Mylan Case dealt with the application of Part IVA, extensive commentary and analysis was provided with respect to the relationship between the Thin Capitalisation Safe Harbours and Part IVA, much of which would be equally/commonly applicable to potentially the interaction of the Transfer Pricing Rules and Thin Capitalisation under firstly, the wider scheme and secondly, the narrower scheme identified by the ATO which dealt with the broader analysis of debt funding vs equity funding – refer to paragraphs 222 and following (including paragraphs 254 and following of the Judgement).

Given that the wider scheme identified by the Commissioner was on one view quite restrictive (and would have resulted in amendments to the transaction documentation and particularly the structure of the acquiring group), we reiterate that these issues must be considered and addressed very carefully, sensitively and reasonably/fairly.

The Judgement in Mylan provides further detailed commentary on a range of indicators including debt to equity ratios, capitalisation of interest, fixed or floating rates, debt service ability, foreign tax position, amortisation of principal, guarantees, group debt position and other financing arrangements throughout the Judgement, which all potentially impact on a commercial and acceptable approach to the 'arm's length debt amount'.

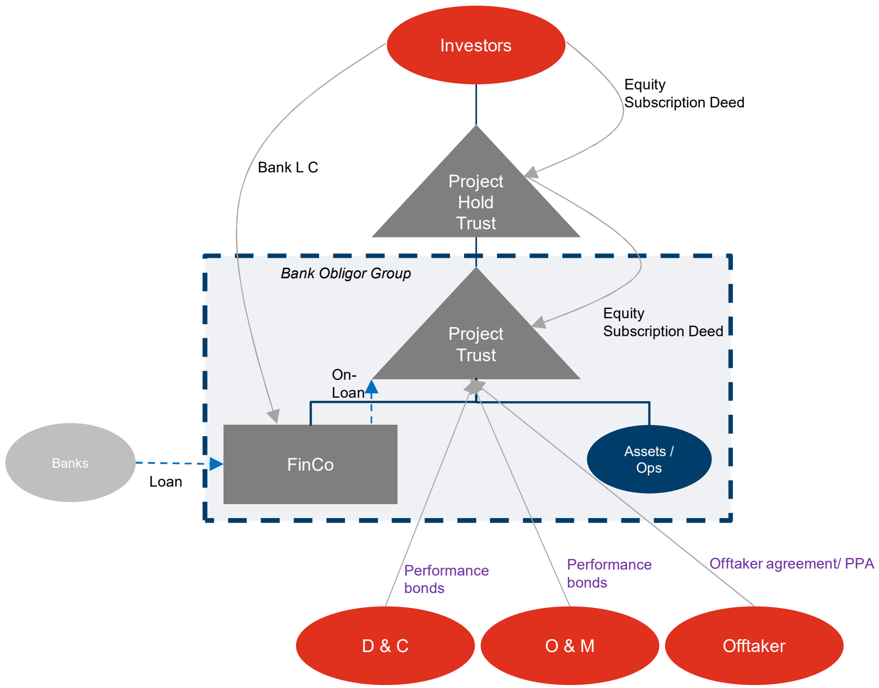
We respectfully request that the proposed guidance for an acceptable approach to the interaction between Thin Capitalisation and the Transfer Pricing Rules be the subject of a 'face to face' meeting in order to properly canvass and address the relevant issues, to be arranged at your earliest convenience.

# Appendix A - Examples

# Example 1 “Recourse”

# – Obligor Group, Australian Assets and Credit Support

# Example 1: Greenfield Renewable Project Example



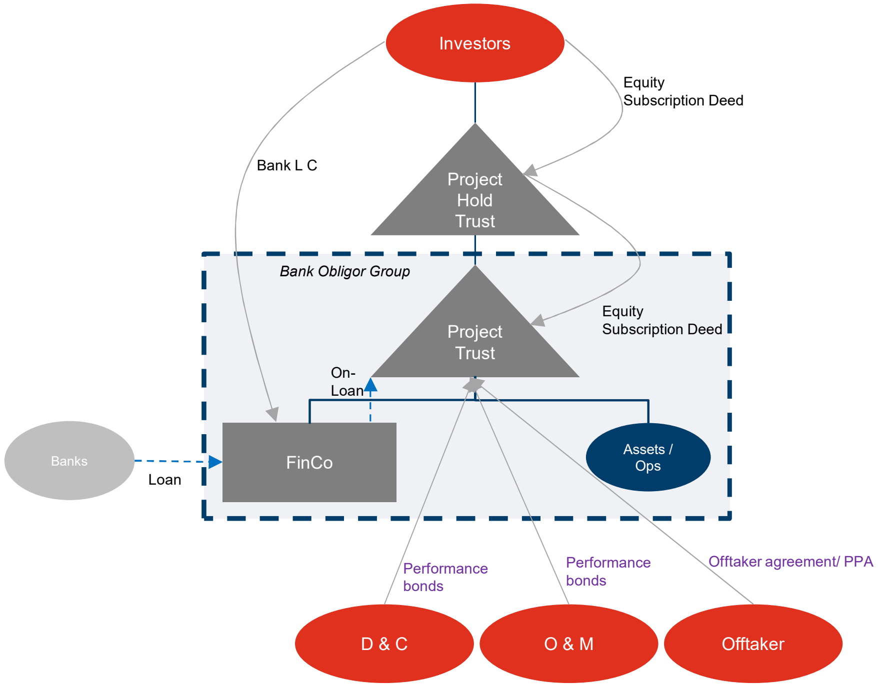

1. The example below is a typical special purpose project financing structure for a single stand-alone renewable energy project. There are no assets of any project entities other than project assets, all located in Australia.

2. Banks enter into a loan facility (Loan) with FinCo pursuant to which banks will lend a fixed facility amount to FinCo. This will be progressively drawn down over the construction period. Banks will also enter into interest rate swap agreements with FinCo to manage interest rate risk.

3. FinCo enters into an On-Loan on back-to-back terms to provide the borrowed funds to Project Trust. FinCo also enters into a back-to-back interest rate swap agreement to match the terms of the bank interest rate swaps.

4. Investors, D & C Contractors, O & M providers and offtakers may enter into commitments regarding the performance of their respective obligations in delivering, operating, purchasing outputs and equity funding in respect of the project. In this regard:
   - D & C Contractors may issue performance bonds/parent guarantees to Project Trust in support of their obligation to design and construct the project.
   - O & M Contractors may issue performance bonds/guarantees in support of their obligation to operate and maintain the project.

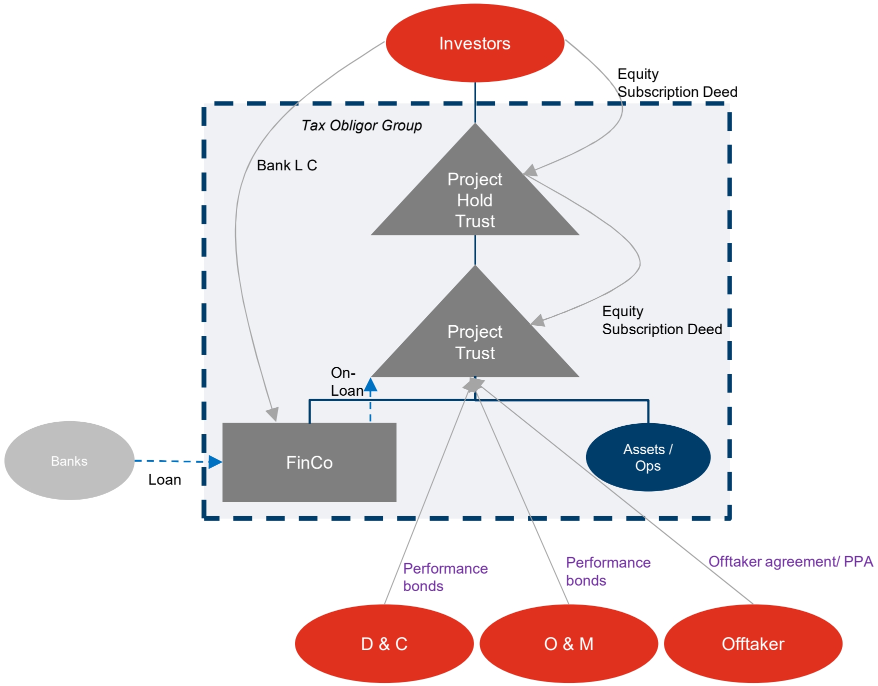
# Example 1: Greenfield Renewable Project Example (cont.)




- An Offtaker may enter into a power purchase agreement (PPA) or derivative contract in respect of the electricity generated by the project which may be supported by guarantees.
- Investors may enter into an Equity Subscription Deed with Project Hold Trust to provide the equity funding. Equity will be drawn down progressively during the construction period. Project Hold Trust has, in turn, entered into an Equity Subscription Deed with Project Trust to provide equity funding.
- Investors may procure LC Banks to provide a letter of credit to FinCo/banks that can be drawn down in the event that Investors/Project Hold Trust fail to meet their obligations under the Equity Subscription Deeds.

5. Project Trust/Project Trustee Co (not shown) are obligors/guarantors in respect of the performance by FinCo under the banking documents. The security trustee for the Banks will also have the benefit of security over FinCo's assets, Project Trust's assets, a charge over the assets of Project Hold Trust including a mortgage over the units in Project Trust and its trustee, and a mortgage over the shares in FinCo. Project Hold Trust is not part of the bank obligor group.

# Example 1: Greenfield Renewable Project Example (cont.)

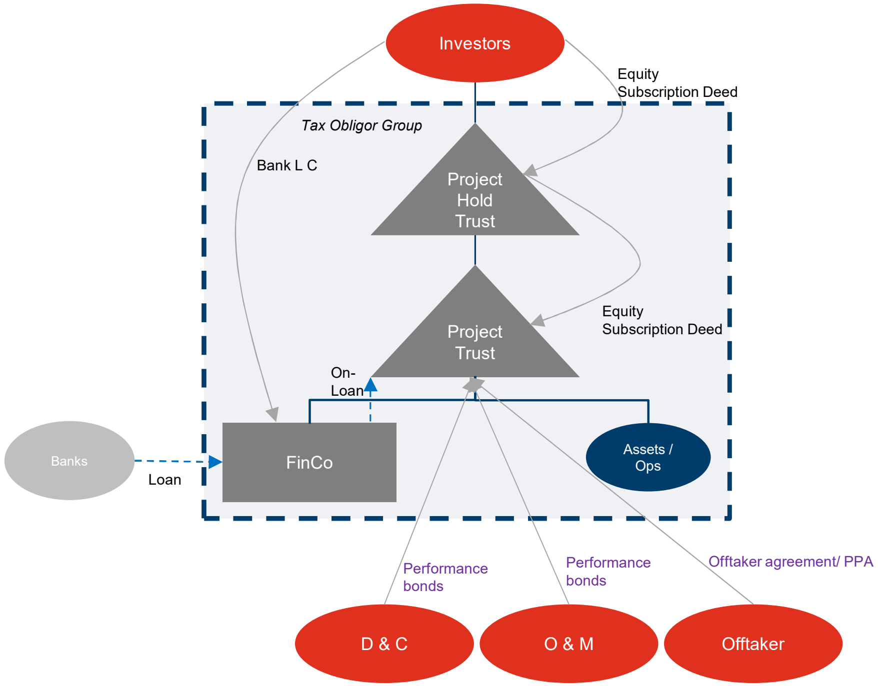



- The example above illustrates a number of interpretation issues with the provisions. The core concepts are determining the members of the “obligor group”, whether there is recourse only to “Australian assets” and the scope of the credit support exclusion in 820-427A(5).

***Obligor Group***

- Section 820-49 provides that “the creditor has recourse for payment of the debt … to one or more entities” (obligor entity) then the borrower and each obligor entity are an obligor group.
- The concept of an “obligor group” is a critical part of the third party debt test. There is limited discussion in the Explanatory Memorandum regarding the scope of the obligor group and when the lender has recourse to one or more assets of another entity. However, it does indicate that this is a “common commercial concept.” Mere giving of security over membership interests in the borrower or conduit financer is disregarded. We believe the obligor group should be limited to the borrower, guarantors and security providers that the lenders have a direct contractual or security right against such as a direct party to the relevant loan agreement which we believe is in line with the common commercial concept.
- In our view, recourse in 820-49 and in 820-427A(3)(c) should exclude indirect recourse. In contrast, the wording in section 820-427A(5)(a)(i)and (ii) dealing with rights that are credit support ,explicitly refers to recourse that arises directly or indirectly and, on this basis, we think involves a broader range of parties to which a lender may have recourse than contemplated in the previous two paragraphs.

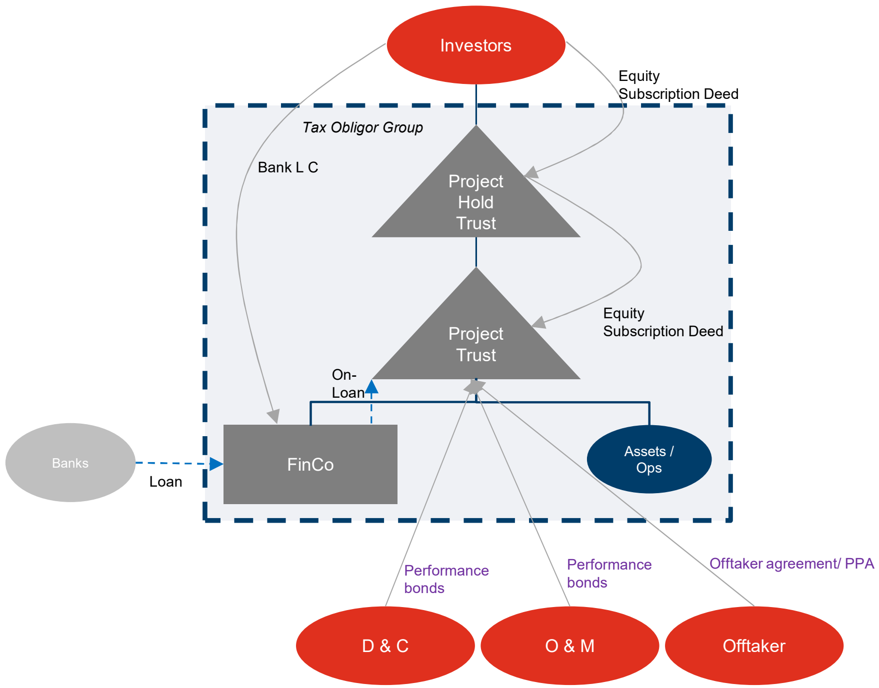
# Example 1: Greenfield Renewable Project Example (cont.)




**<u>Recourse provided under D&C Contracts and O&M Contracts</u>**

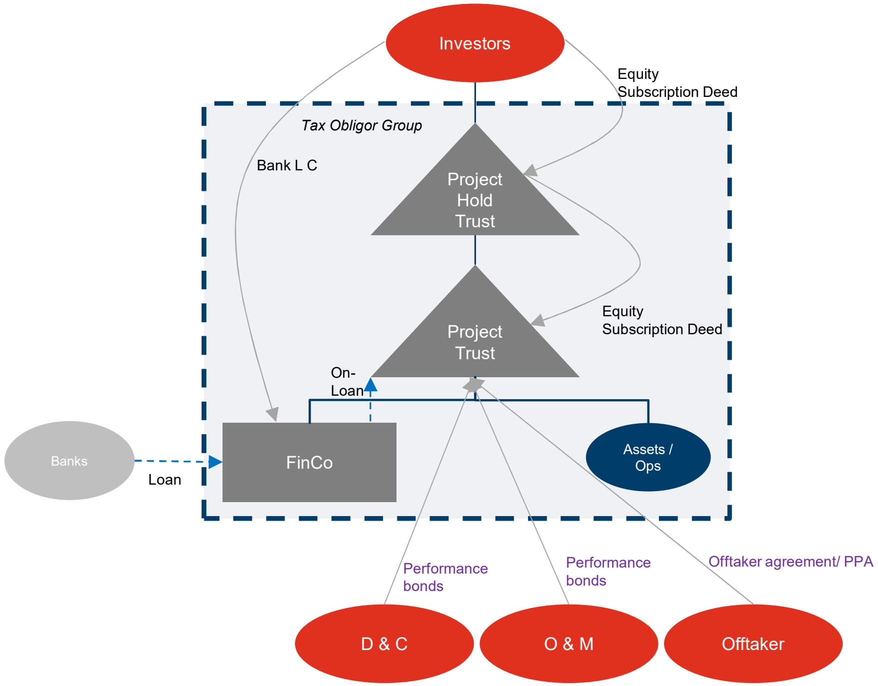
- A threshold issue is whether the Banks should be considered to have direct or indirect **<u>"recourse for the payment of the debt to which the debt interest relates"</u>** to the assets of the following parties:
  - The assets of a D&C Contractor or O&M Contractor who has provided certain indemnities or warranties regarding the delivery of their services
  - The assets of another bank who may have provided a performance bond in support of the indemnities and warranties provided by the D&C Contractor or O&M Contractor
  - The assets of parent company of the D&C Contractor or O&M Contractor that has provided a parent company guarantee in support of those warranties and indemnities
- It is submitted that the Banks should only be considered to have direct or indirect recourse for these purposes where that recourse is available at all relevant times or at least <u>in the event of a default under the financing documents</u>. It is submitted that recourse can only be considered "recourse for the payment of the debt" where it is in fact available at the time the debt is required to be repaid or enforced.
- In each of the above cases, the contingent rights (being the benefit of indemnities, warranties, performance bonds, parent company guarantees) held by the Project Trust are assets to which the Banks would have recourse as part of its all asset security.
- However, it is submitted that these contingent rights only provide recourse to the assets of the D&C Contractor, O&M Contractor, performance bond provider or parent company <u>at a time when the indemnities or warranties are actually triggered</u> – which is when there is a default under the D&C Contract or O&M Contract.

# Example 1: Greenfield Renewable Project Example (cont.)




- An event of default under the finance documents does not automatically trigger the indemnities or warranties under the D&C Contract or O&M Contract. That is, when the Banks seek to enforce the debt in an event of default they will not have recourse to the assets of D&C Contractor, O&M Contractor, performance bond provider or parent company for payment of the debt unless there is, by coincidence, also a default arising under the D&C Contract or O&M Contract at the same time.
- For this reason, it is submitted that indemnities and warranties and supporting commitments provided under a D&C Contract or O&M Contract should not be considered to provide direct or even indirect recourse for the payment of the debt as required by section 820-49(1)(b) and section 820-427A(3).
- It is submitted this is consistent with a proper interpretation of the rules and also the commercial reality that the indemnities, warranties and supporting commitments are provided in respect of the delivery of services under an D&C Contract or O&M Contract not to support repayment of the debt. Therefore, while they may be accepted as contingent assets of the Project Trust to which the Banks have recourse, they should not be considered to provide direct or indirect recourse to the Banks to assets of D&C Contractor, O&M Contractor, performance bond provider or parent company.
- In the alternative and a less preferred interpretation, it its submitted that it is only in an income year where a claim under the indemnity or warranty is triggered that the Banks would be considered to have such recourse – and in this case the recourse would be considered indirect recourse given the Banks are only able to access the assets of those parties through Project Trust.

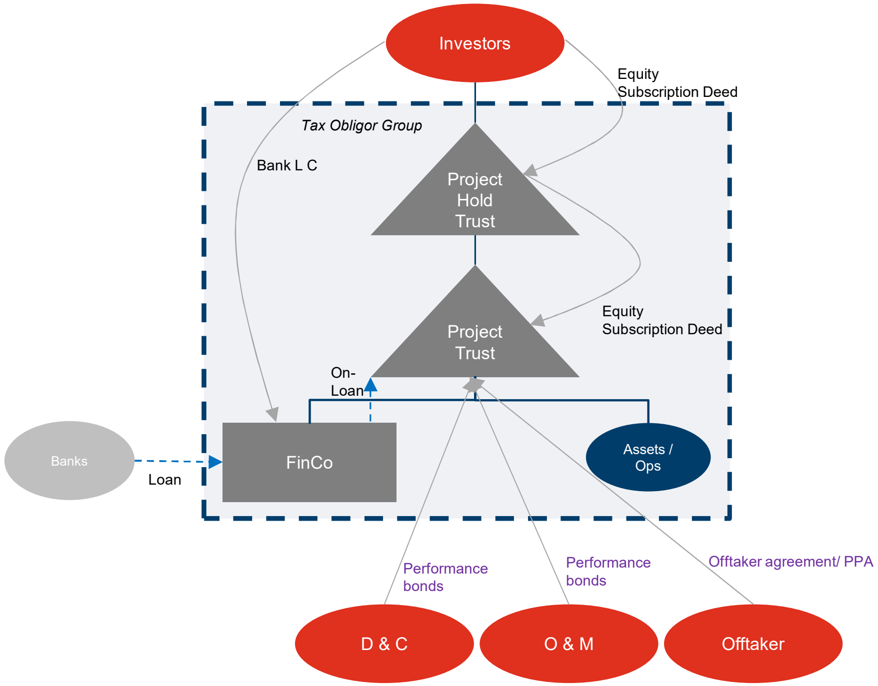
# Example 1: Greenfield Renewable Project Example (cont.)




**Recourse provided under Offtake agreements**

- For similar reasons as those outlined above, any contingent right in the form of an indemnity or warranty under an Offtake agreement may be considered an asset of the Project Trust to which the Banks have recourse.
- However, as recourse only be provided to the assets of the Offtaker in the event a claim is made under the indemnity or warranty it should not be considered that the Banks have direct or indirect recourse to the assets of the Offtaker (or a parent company or banks bonding or guaranteeing those indemnities and warranties) **"<u>for the payment of the debt</u>"** for the purposes of section 820-49 and section 820-427A(3).
- In the alternative and a less preferred interpretation, it is submitted that the Banks would only have <u>indirect</u> recourse to the assets of the Offtaker or the supporting parent or banks bonding or guaranteeing those indemnities and warranties at a time when there is a claim triggers under those arrangements. Again this would not be recourse for the purposes of section 820-49 or section 820-427A(3) but may be indirect recourse for the purposes of section 820-427A(5).
- Again, we consider this accords with the technical requirements of the law but also the practical reality that the above arrangements are intended to support the offtake arrangements and do not relate to the repayment of the debt.

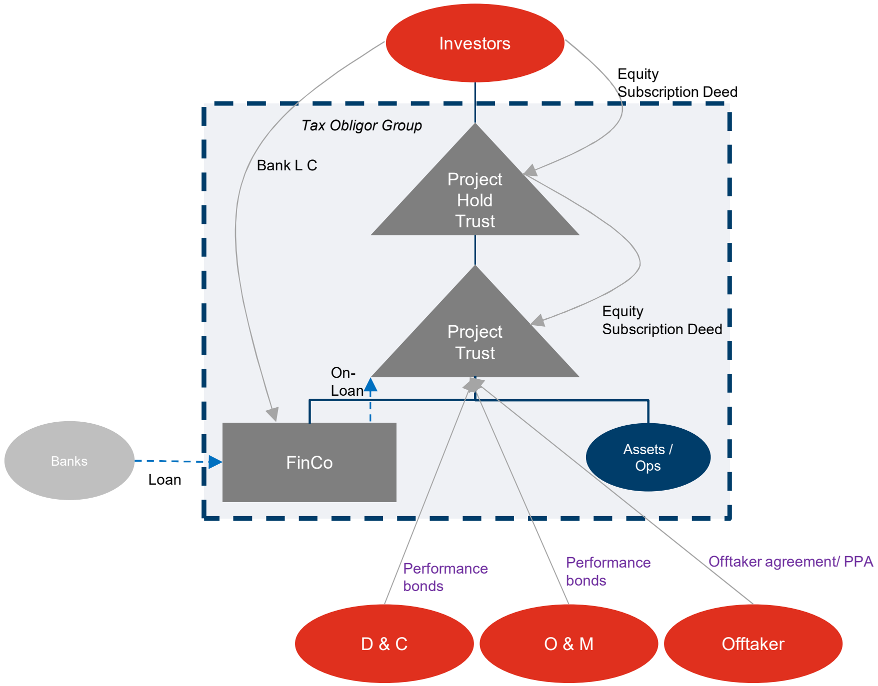
# Example 1: Greenfield Renewable Project Example (cont.)




**Recourse provided under Equity Commitment Deeds and supporting Letters of Credit**

- Banks will typically have the right to call on equity commitments provided by Investors and any supporting letters of credit when they seek to enforce the debt in the event of a default under the financing documents.
- Therefore, it may be accepted that those rights held by Project Trust are assets to which the Banks have at least indirect recourse as outlined below.
- In some cases, letters of credit are held by the Security Trustee with the Banks as a direct beneficiary. Although it is considered an unintended consequence of the new rules, it may be argued that in this case the Banks have direct recourse to the assets of the letter of credit provider for the repayment of the debt for the purposes of section 820-49 and section 820-427A(3).
- However, in other cases, the Banks have no direct recourse to the letter of credit and must instead access the letters of credit indirectly through NOP (under a power of attorney or otherwise). In these cases, it is submitted that the Banks only have indirect recourse to the assets of the letter of credit provider which should not be considered recourse for the purposes of section 820-49 and section 820-427A(3). Such indirect recourse would be relevant to consider for the purposes of section 820-427A(5).
- While the difference between these arrangements is arguably subtle it may have a significant impact on the application of the third party debt test. Therefore, the Commissioner is requested to provide clear guidance around these matters in order to provide the necessary certainty to taxpayers.

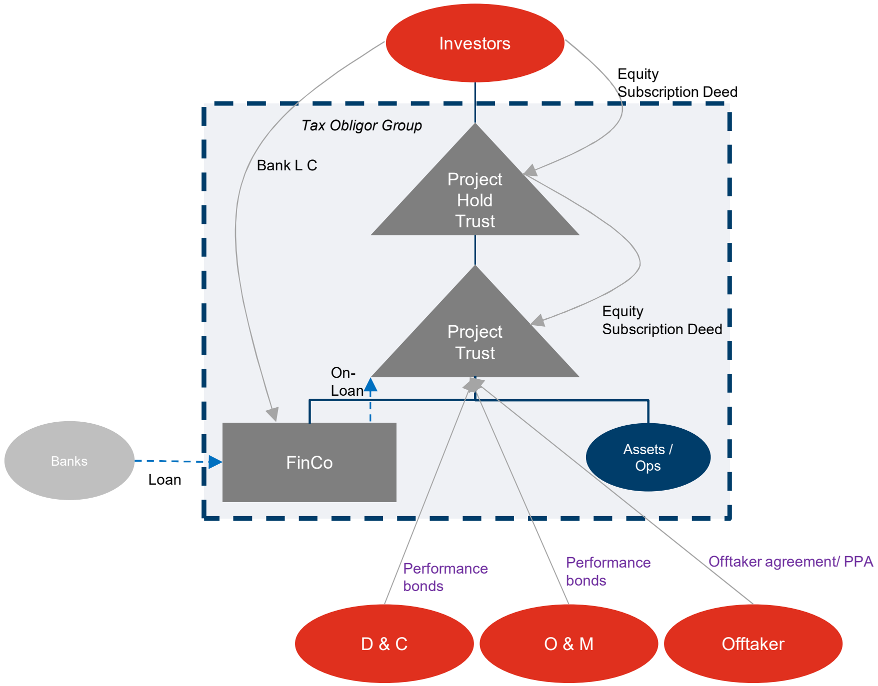
# Example 1: Greenfield Renewable Project Example (cont.)




**Collateral provided to Letter of Credit providers**

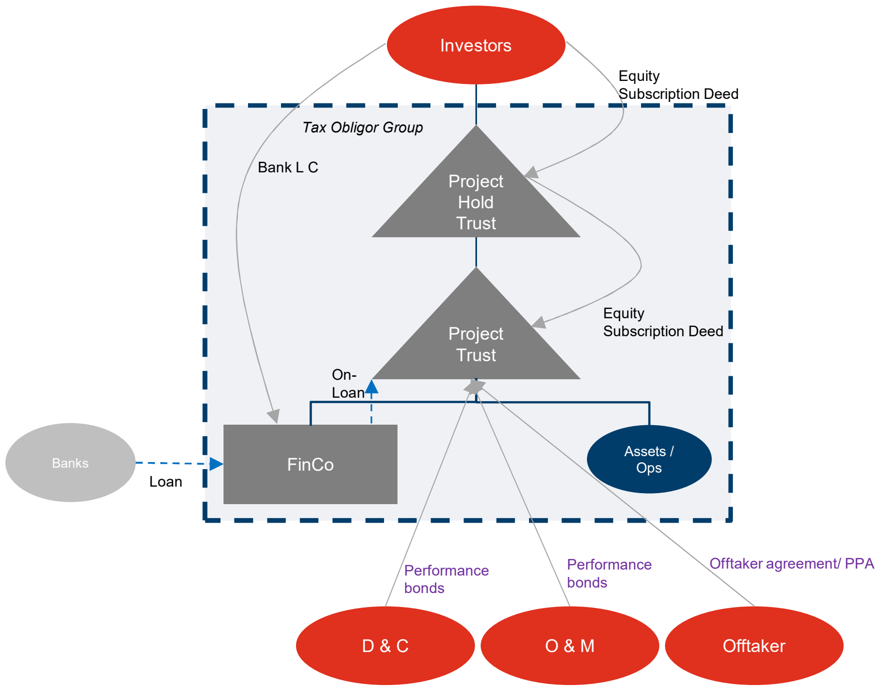
- It is generally the case that a letter of credit provider will require some form of guarantee or collateral to be provided by the parent or group company of the borrower that can be called in the event the letter of credit is called by the lending Banks. In many large infrastructure projects, the parent company may be a foreign associate entity of the borrower.
- On one view, it may be considered that the provision of collateral by the parent company provides the lending Bank with indirect recourse to the assets of that parent company. This is despite the obvious fact that the Bank is relying on the overall balance sheet of the letter of credit provider (rather than in any material sense the collateral provided by the parent company) in providing the financing.
- It is submitted that such indirect recourse is clearly does not provide direct recourse of the lending Bank to the parent company for the purposes of section 820-49 nor section 820-427A(3).
- However, the Commissioner should provide guidance as to whether the collateral provided to the letter of credit provider (which may be in the form of a cash deposit or explicit or implicit guarantee) should be considered to provide indirect recourse for the purposes of section 820-427A(5). Where the parent is a foreign associate entity of the borrower this will have particular relevance to determining whether section 820-427A(5)(b) may apply.
- It is submitted that capturing such collateral as indirect recourse for these purposes was not an intended outcome under the rules. That is, the letter of credit provides the support and access to the assets of the letter of credit provider in support of the Bank's lending decision. Therefore it is only the indirect recourse to the balance sheet of the letter of credit provider that is relevant to consider in these circumstances.

# Example 1: Greenfield Renewable Project Example (cont.)




- More generally and in addition to the specific cases noted above, where a third party bank (LC bank) provides a letter of credit to support the performance of a counterparty to the borrower (e.g. offtaker, service provider) then the lender might be argued to have indirect recourse to the LC bank/counterparty assets. We do not think that such indirect credit support should make those entities obligors for the reasons stated above. If, contrary to our view, these arrangements were counted as a recourse which made those third parties obligors or if that type of indirect recourse was counted for the purpose of section 820-427(3)(c), then the third party debt test would not be available in many unintended situations.
- “Recourse” in our view is intended to have a much narrower definition than the direct or indirect references in section 427A(5) may permit.

# Example 1: Greenfield Renewable Project Example (cont.)




***Australian Assets***

- Section 820-427A(3)(c) provides that "the holder of the debt has recourse for the payment of the debt only to" certain Australian assets covered by (4) and not covered by (5).

***Credit support rights covered by (5)***

- Section 820-427A(5) deals with "a right under or in relation to a guarantee, security or other form of credit support". Importantly, in paragraph (a)(i), it uses the concept of recourse directly or indirectly "only to one or more Australian assets covered by subsection (4)". At the end of Section 820-427A(5)(a)(i) this is qualified by adding "that are not rights covered by this section". The supplementary memorandum makes it clear these extra words refer to credit support rights other than the assets covered in subsection (4). Confirmation of this interpretation in the tax ruling would be helpful.
- In the example above, the performance guarantees or performance bonds provided by D&C, O&M and offtakers to the Project Trust should not be a right covered by Section 820-427A(5) on the basis that they are not a form of credit support (refer to paragraph 2.99 of the Explanatory Memorandum which states that "*recourse to rights under or in relation to <u>forms of credit support</u> (referred to in the following paragraphs as 'credit support rights') are generally prohibited to ensure that multinational enterprises do not have an unfettered ability to fund their Australian operations with third party debt.*" In any event those rights are not provided by associate entities and hence section 820-427A(5)(a)(ii) should exclude such rights.

# Example 2

# – Hedging and Interest Rate Swaps

# Example 2 – Hedging and Interest Rate Swaps

## Conduit financing and swaps

**Approach to Examples**

We have provided below a number of different examples, dealing with the issues that arise in a conduit financing arrangement where interest rate swaps are either in-the-money (ITM) or out-of-the-money (OTM). We have considered two alternate conduit approaches that Finco may adopt to pass through interest expenses as well as the benefit/burden of its interest rate hedging arrangements to Project Trust. In each case Finco is intended to be a breakeven entity.

We have approached each example as follows:

1. Identify the relevant "debt deductions" for FinCo and Project Trust.
2. Identify which debt deductions (if any) relating to interest rate swaps meet the conditions in subsection 820-427A(2).
3. For FinCo, consider if the third party debt conditions are met in relation to the bank loan.
4. For Project Trust, consider if conduit financing conditions are satisfied, and if so, whether the third party debt conditions (as modified) are met in relation to the on-loan (and, where relevant, on-swap).

# Example 2 – Hedging and Interest Rate Swaps

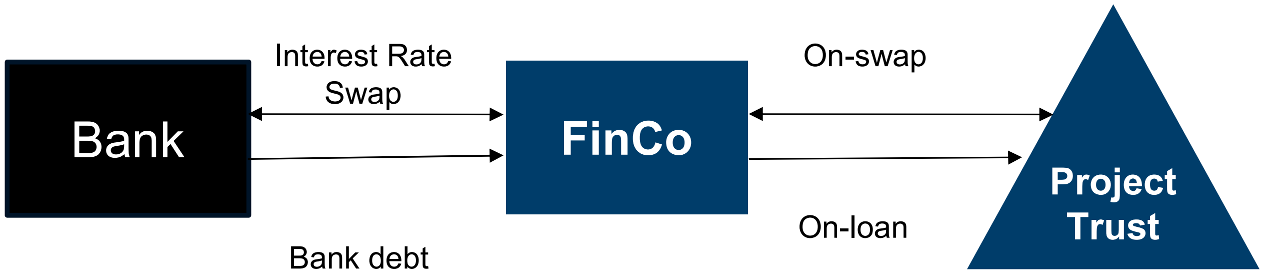
## Conduit financing and swaps

**Summary of issues**

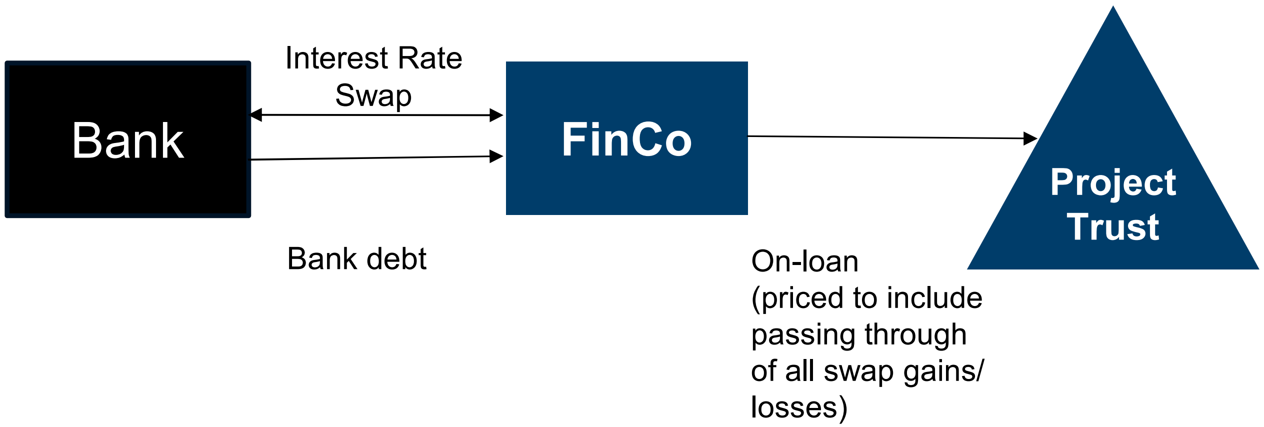
- FinCo and Project Trust from Example 1 both seek to utilise the third party debt test (TPDT) incorporating the conduit financing conditions for Project Trust. Without access to the TPDT, potentially $ billions of debt deductions are at risk across a wide range of infrastructure and real asset investment structures.
- Project Trust and FinCo are associate entities. The third party bank lenders and swap counterparties are unrelated to FinCo and Project Trust.
- Under Scenario1 Finco on-lends funds it has received from third party banks and enters into identical on-swaps to Project Trust. Under Scenario 2 Finco on-loans funds it has received from third party banks and passes through the external swap gains/losses by adjusting the on-loan interest rate.
- The current provisions relating to the third party debt test, conduit financing and hedging are throwing up a number of issues, including:
    - The definition of "debt deduction" and how/if this applies to FinCo passing through net hedge gains to Project Trust.
    - Whether costs relating to the on-swap can be included in Project Trust's third party earnings limit as FinCo and Project Trust are associate entities (Scenario 1).
    - The ability for FinCo to pass through swap gains (as opposed to losses) as part of the on-loan and still satisfy the conduit financing conditions (Scenario 2)..
- There are significant costs (both commercial and tax) involved with potentially restructuring these arrangements, particularly as many taxpayers have unrealised swap gains due to recent increases in interest rates.

## Conduit financing and swaps

**Scenario 1**
- back-to-back loan and swap on identical terms




**Scenario 2**
- loan and swap combined into one on-loan from FinCo to Project Trust



# Example 2 – Hedging and Interest Rate Swaps

## Example A : Scenario 1 OTM Swap (IR)

**1. Identifying "debt deductions" for Project Trust**

Project Trust:

- On-Loan interest expense
- On-Swap net loss (fixed leg > floating leg)

**Issue: Our view is that a taxpayer is required to calculate debt deductions on an interest rate swap on a net (not gross) basis as it is a single financial arrangement. 230-15 provides that a gain/loss ie a net figure (notwithstanding there are two swap legs with a notional principal that have to have gains/losses calculated separately per 230-120). Finco receives variable interest and pays fixed interest under the swap legs. Section 230-15 then nets these two numbers to determine a singular gain/loss.**

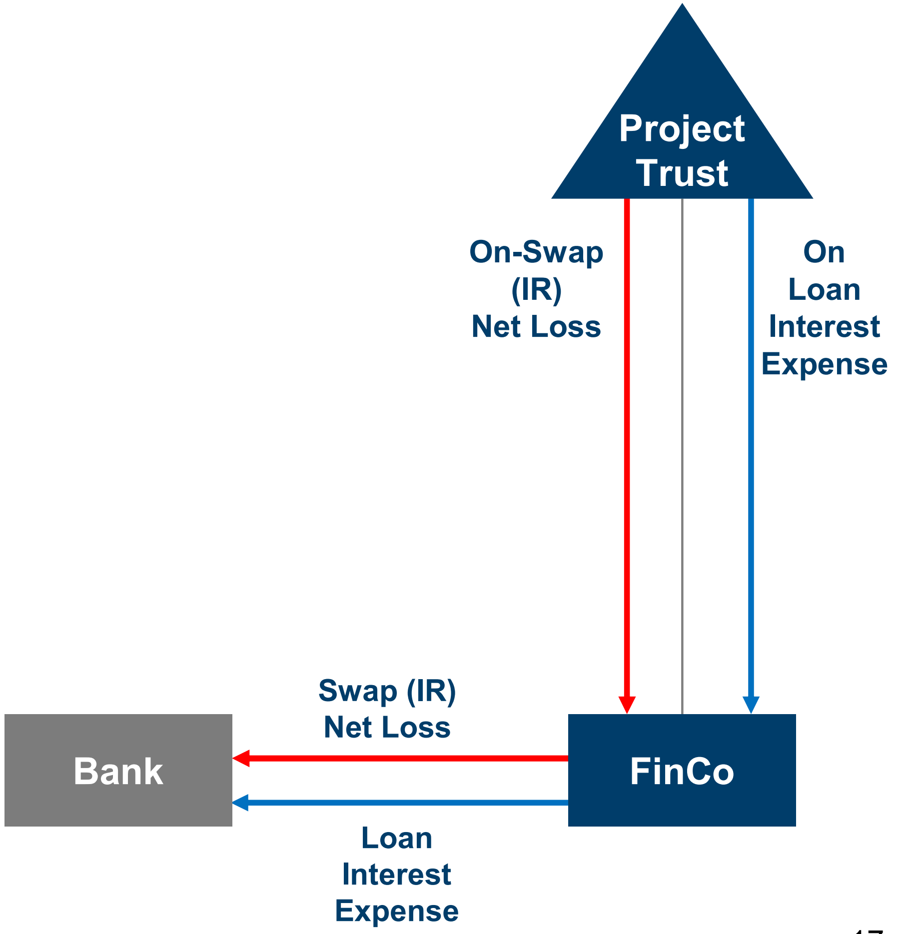
**2. Calculating "third party earnings limit" for Project Trust** (assuming 820-427C conduit financing conditions met)

Project Trust:

- Modifications in 820-427B do not modify 820-427A(1) or (2)
- On-Loan is the "relevant debt interest" (assuming it satisfies the conduit financing conditions) for 820-427A(1)
- Third party earnings limit therefore includes interest on the On-Loan
- **Issue: "Debt deduction" on an On-Swap cannot be treated as attributable to a debt interest issued by Project Trust under 820-427A(2), if it fails condition (2)(b). The debt deduction is paid by Project Trust to an associate entity (FinCo and Project Trust are associate entities) but is ultimately referable to an amount paid to a third party swap counterparty and hence (2)(b) does not apply.**
- **If this interpretation is not accepted then the third party earnings limit of Project Trust could be less than total debt deductions and debt deductions on On-Swap (IR) could be denied.**

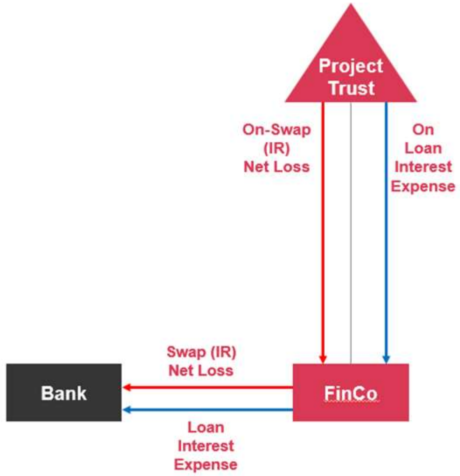
**3. Meeting 820-427C conduit financing conditions**

- 820-427C(1)(d) requires the On Loan to be on same terms as Loan.
- Should readily be met in this case.



# Example 2 – Hedging and Interest Rate Swaps

## Example A : Scenario 1 OTM Swap (IR) (cont.)




**Whether costs relating to the on-swap can be included in Project Trust's third party earnings limit (Scenario 1)**

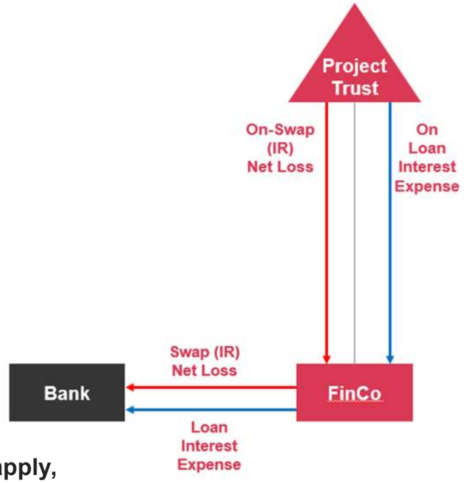
- Where the external swap is "out of the money" in Scenario 1, Project Trust is required to compensate FinCo for these losses under the on-swap.
- As set out above, in this case, the losses arising to Project Trust under the on-swap should be debt deductions as the on-swap relates to the financing of the entity under the on-loan. Therefore, we need to consider if these debt deductions are included in Project Trust's third party earnings limit, and specifically, whether the requirements of subsection 820-427A(2) are met.
- Under subsection 820-427A(2), a debt deduction will be treated as being attributable to a debt interest issued by the entity to the extent that:

  **a) it is directly associated with hedging or managing the interest rate risk in respect of the debt interest; and**
  **b) it is not referable to an amount paid or payable, directly or indirectly, to an associate entity.**

- It seems clear that the costs incurred by Project Trust under the on-swap would be directly associated with hedging or managing interest rate risk in relation to the on-loan, which is a debt interest issued by Project Trust.
- The issue is that this debt deduction arises due to an amount that is payable to FinCo, an associate entity of Project Trust. As a result, the condition in subsection 820-427A(2)(b) appears not to be satisfied. The modifications for conduit financing provided under 820-427B do not alter the requirements in paragraph 820-427A(2)(b), and as such, the Project Trust must satisfy them so as to include the costs relating to the on-swap in its third party earnings limit.
- We believe the section is not directed at amounts that are paid to an associate entity where that associate entity in turn on-pays that amount to a third party. We believe that interpretation is supported by the use of the expressions "referable to" and "directly or indirectly" and looking at the history of amendments to the Bill and commentary in the EM and Supplementary EM specifically referencing a conduit borrowing chain. If for example an amount was paid to a third party but that third party on paid it to an associate entity then the provision would not be satisfied.
- The Bill initially provided protection from the operation of 820-427A(2) for conduit arrangements via 820-427B(2) which was later removed when that subsection was rewritten. The original Explanatory Memorandum provided (at paragraph 2.108) the following commentary on the use of interest rate hedging arrangements in conduit financing arrangements.

# Example 2 – Hedging and Interest Rate Swaps

## Example A : Scenario 1 OTM Swap (IR) (cont.)




**Whether costs relating to the on-swap can be included in Project Trust's third party earnings limit (Scenario 1) (cont)**

- **"When applying the third party debt conditions to a debt interest under the conduit financing conditions, the following modifications are made to the third party debt conditions:**
  **- for a relevant debt interest – the allowance for debt deductions under interest rate swap arrangements under subsection 820-427A(2) does not apply, meaning that debt deductions of borrowers under interest rate swap arrangements are disallowed;**
  **- for a relevant debt interest – the entity is deemed to satisfy paragraphs 820-427A(2)(a) and (b) requiring an entity issue the debt interest to an entity which is not an associate entity)...."**

- Section 820-427B(2) was initially drafted so that payments under an on-loan (relevant debt interest) and on-swap would be deductible as they were deemed to satisfy this test in 820-427A(2). The text above makes it clear that this is the specifically intended outcome.

- **820-427B as it was is reproduced below.**

  ***"Special rules for third party debt conditions—relevant debt interest***
  **820-427B(2) Disregard subsection 820-427A(2) in relation to a relevant debt interest mentioned in subsection 820-427C(1)."**

  820-427B was subsequently rewritten and this protection was removed. The commentary at paragraph 1.25 in the Supplementary EM concerning conduit arrangements does not explain its withdrawal but further expressed the view at paragraph 1.25 that conduit arrangements involving swaps applying down a borrowing chain of associate entities should be effective.

  **"In conduit financer cases, an interest rate swap cost incurred by a borrower is now generally deductible under the third party debt test, to the extent subsection 820-427A(2) is satisfied in relation to the cost. Additionally, borrowers can recover these costs from other borrowers further down the 'borrowing chain'.**
  **[Amendment 79, paragraph 820-427C(2)(e)]"**

  **"Several refinements have been made to sections 820-427C and 820-427B to clarify the operation of these sections and ensure correct outcomes are achieved. The refinements also ensure a reasonable degree of flexibility in how the sections operate. For example, where a relevant debt interest fails the conduit financing conditions in 820-427C, then this does not necessarily result in the related ultimate debt interest and other relevant debt interests failing the conduit financing conditions."**

- Based on the above extracts, we believe that interpreting the rules broadly to allow Project Trust deductions for hedging costs in these circumstances is supported.

# Example 2 – Hedging and Interest Rate Swaps

## Example B : Scenario 1 ITM IR Swap

**1. Identifying "debt deductions"**

FinCo:

- Loan interest is a debt deduction
- Swap net gain (fixed leg < floating leg (FinCo has a net gain on ITM external Swap), so not relevant.
- Internal Swap net loss on on-paying the ITM swap gain– is not a debt deduction as it is hedging gain that relates to the on-loan which is a receivable and not a payable for Finco.

Project Trust:

- On-Loan interest expense is a debt deduction
- On-swap net gain received (fixed<floating) is assessable but not a debt deduction

**2. Calculating "third party earnings limit" for Finco**

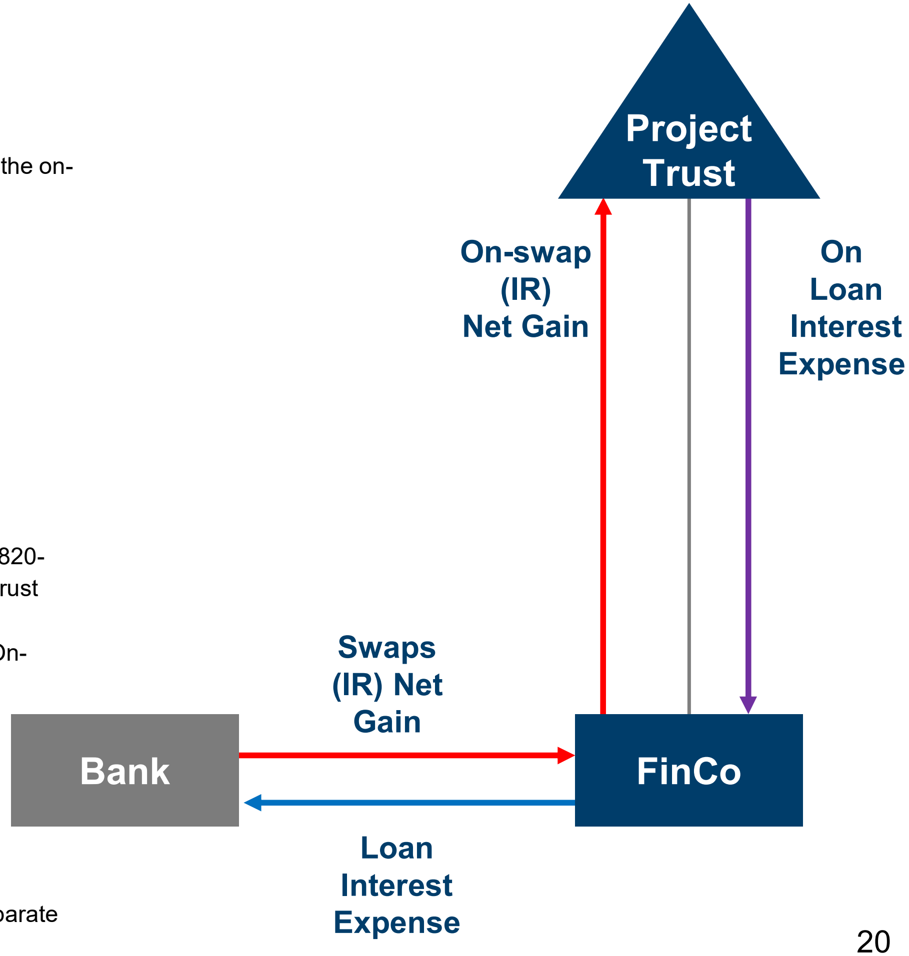
If payment of swap loss to Project Trust were, contrary to our view, treated as a debt deduction:

- Modifications in 820-427B does not modify 820-427A(1) or (2)
- External Loan is the "relevant debt interest" for 820-427A(1)
- Third party earnings limit therefore includes interest on the External Loan
- Issue: "Debt Deduction" on the On-swap cannot be treated as attributable to a debt interest issued by Finco under 820-427A(2) if it fails condition (b). Concern is that the debt deduction is paid to an associate entity (Finco and Project Trust are associate entities) but is ultimately referable to a swap gain received from a third party.
- Therefore Third Party Earnings Limit of Finco could be less than total debt deductions and the debt deductions on On-swap (IR) (if they are regarded as a debt deduction) could be denied.

**3. Calculating "third party earnings limit" for Project Trust** (assuming 820-427C conduit financing conditions met)

Project Trust:

- Modifications in 820-427B do not modify 820-427A(1) or (2)
- On-Loan is the "relevant debt interest" (assuming it satisfies the conduit financing conditions) for 820-427A(1)
- Third party earnings limit therefore includes interest on On-Loan, which includes full interest (swap amount is a separate gain)



# Example 2 – Hedging and Interest Rate Swaps

## Example C : Scenario 2 OTM IR Swap, embedded into On-Loan

**1. Identifying "debt deductions"**

FinCo:

- Loan interest expense
- Swap net loss (fixed leg > floating leg)

Project Trust:

- On-Loan interest expense (which includes On-Swap net loss)

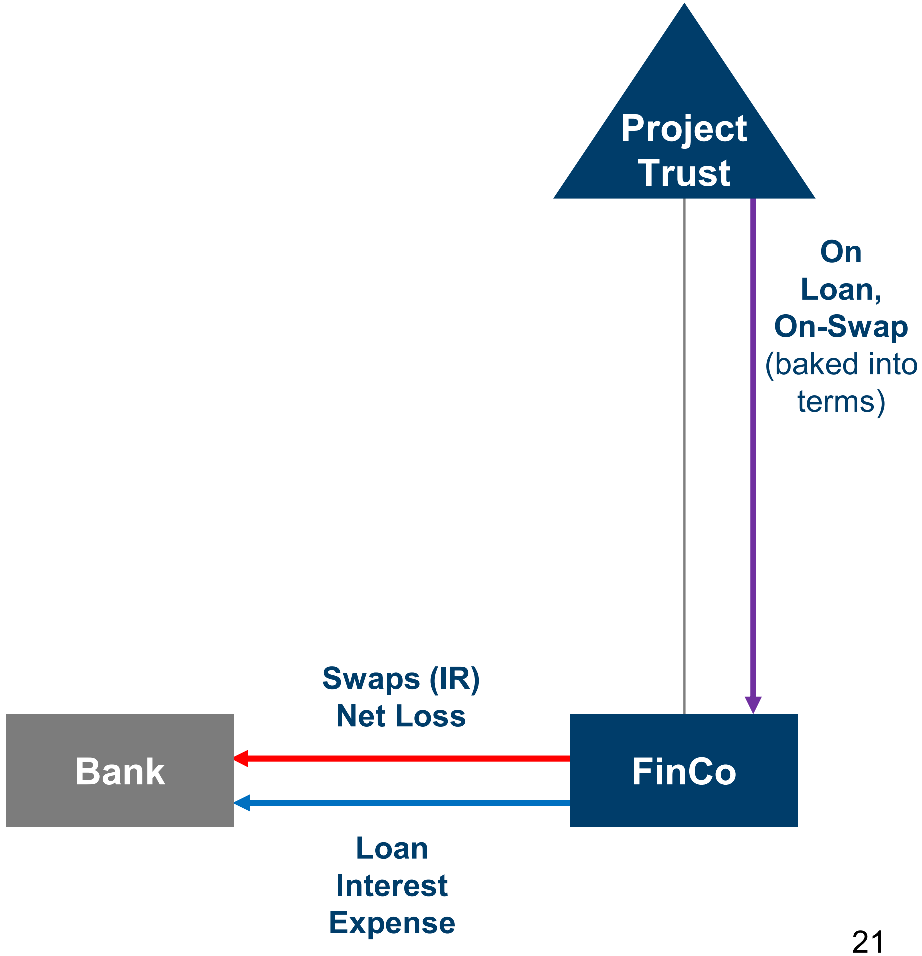
**2. Calculating "third party earnings limit" for Project Trust** (assuming 820-427C conduit financing conditions met)

Project Trust:

- Modifications in 820-427B do not modify 820-427A(1) or (2)
- On-Loan is the "relevant debt interest" (assuming it satisfies the conduit financing conditions) for 820-427A(1)
- Third party earnings limit therefore includes interest on On-Loan, which includes full interest + swap loss amount

**3. Meeting 820-427C conduit financing conditions**

- 820-427C(1)(d) requires On Loan to be on same terms as Loan.
- 820-427C(2)(d) says "*disregard the terms of the [On-Loan] to the extent that those terms have the effect of allowing the recovery of costs of [FinCo] that: (i) are a debt deduction for the income year of the conduit financier; and (ii) are a debt deduction that is treated as being attributable to the ultimate debt interest under subsection 820-427A(2)*"
- Should be met, as Swap (IR) loss is a debt deduction of FinCo, and meets 820-427A.



# Example 2 – Hedging and Interest Rate Swaps

## Example D : Scenario 2 ITM IR Swap, embedded into On-Loan

**<u>1. Identifying "debt deductions"</u>**

FinCo:

- Loan interest expense
- FinCo has a net gain on ITM Swap that is not a debt deduction

Project Trust:

- On-Loan interest expense (which is reduced by On-Swap net gain)

**<u>2. Calculating "third party earnings limit" for Project Trust</u>** (assuming 820-427C conduit financing conditions are met)

Project Trust:

- Modifications in 820-427B do not modify 820-427A(1) or (2)
- On-Loan is the "relevant debt interest" (assuming it satisfies the conduit financing conditions) for 820-427A(1)
- Third party earnings limit therefore includes interest on On-Loan, which includes interest expense – net of the on-swap gain amount.

**<u>3. Meeting 820-427C conduit financing conditions</u>**

- 820-427C(1)(d) requires On Loan to be on same terms as Loan.
- 820-427C(2)(d) says "*disregard the terms of the [On-Loan] to the extent that those terms have the effect of allowing the <u>recovery of costs of [</u>FinCo] that: (i) <u>are a debt deduction</u> for the income year of the conduit financier; and (ii) are a debt deduction that is treated as being attributable to the ultimate debt interest under subsection 820-427A(2)*"
- **Issue: FinCo makes a gain on IR swap, and so has no "costs" to recover for (2)(d), and the swap gain amounts cannot be disregarded under (2)(d)(i) as they are not a "debt deduction". Therefore, reading the provision literally the On-Loan and Loan are on different terms (due to the reduction in interest rate of the On-loan for the Swap terms), and arguably conduit financing conditions might be failed. We read the provisions more broadly to acknowledge that the costs recovered can be net costs (net of swap gains).**