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SUBMISSION TO THE AUSTRALIAN TAXATION OFFICE IN RESPONSE TO ITS CONSULTATION ON PROPOSED CHANGES TO THE THIN CAPITALISATION REGIME

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.

Please find below a submission to the Australian Taxation Office (ATO), prepared by Infrastructure Partnerships Australia's Tax Policy Taskforce, in response to the ATO's consultation process on Draft Taxation Ruling TR 2024/D3 Application of thin capitalisation third-party debt test and Schedule 3 of Draft Practical Compliance Guideline PCG 2024/D3.

Infrastructure Partnerships Australia and its Tax Policy Taskforce looks forward to further assisting the ATO on this consultation. If you require additional detail or information, please do not hesitate to contact Katie Dempsey at katie.dempsey@infrastructure.org.au.

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Responses to Draft Taxation Ruling and Draft Practical Compliance Guidance

1. Third party debt test is intended to be a "simpler and more streamlined test"

An initial submission the Taskforce considers should be borne in mind when formulating guidance for the third party debt test ("***TPDT***") is that the test *"is intended to be a* ***simpler and more streamlined test to apply and administer than the arm's length debt test (ALDT)"*** (refer to paragraph 2.91 of the Explanatory Memorandum to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024* (Cth) *("**EM**"))*.

As outlined in more detail in the submissions below, if the current draft guidance is not amended, taxpayers will be required to undertake complex and costly restructures and/or trace the historical and ongoing use of funds in circumstances where their existing third party financing arrangements do not breach the legislative requirements of the test when read in their proper context and with reference to the policy objectives outlined in the EM. Moreover, if the draft guidance is to be followed, then far from being a simpler and more streamlined test to administer than the ALDT the TPDT, will be extremely difficult and costly to satisfy at all outside of the most basic hypothetical scenarios. Such an approach does not cater for practical requirements for financing even wholly Australian infrastructure projects and businesses.

Equally, the draft guidance appears to have overemphasised the scope of the statement "*the third party debt test is designed to be narrow*" in paragraph 2.92 of the EM and does not take proper account of the EM guidance that follows that statement, including:

> "[*the test] is* ***designed to accommodate*** *only* ***genuine commercial transactions related only to Australian business operations***"
>
> *"the test* ***balances the tax integrity policy intent*** *and the need to* ***ensure genuine commercial arrangements are not unduly impeded****"*

The Taskforce acknowledges the TPDT is intended to be narrower than the ALDT it replaces. First, it applies only to genuine third party debt and not to related party debt. Second, it completely denies debt deductions in circumstances where the former ALDT would merely limit the debt deductions available based on determining the maximum allowable debt applying relevant facts and assumptions. For example, under the former ALDT, the requirement to disregard industry standard credit support arrangements may have reduced the arm's length debt amount but still resulted in maximum allowable debt at or around the amount of average adjusted debt. Under the TPDT, such credit support would result in all the debt deductions for the financing being denied.

Accordingly, there is no question that on any reading the TPDT is significantly narrower than the arm's length debt it replaces – even in the case of industry standard financing arrangements.

However, the Taskforce respectfully submits that the statement "designed to be narrow" in the EM does not justify a legislative interpretation, much less a practical compliance approach, on every issue that is overly restrictive, uncommercial and does not properly balance the tax integrity intent of the test with the practical requirements of genuine commercial financing arrangements.

2. What constitutes an "Australian asset" for the purposes of applying the third-party debt conditions in section 820-427A?

Legislative context

The legislature has not expressly defined the term "Australian asset" for the purposes of paragraph 820-427A(3)(c).

The ATO states that "whether an asset is an 'Australian asset' depends on the facts and circumstances, including the nature of the asset involved, and its connection to Australia".[1]

The ATO further states that:

1. A foreign bank account of an Australian company used in carrying on a business in Australia is not an Australian asset[2]
2. A share in a company that is both a tax resident and domiciled in Australia for Corporations law purposes is not an Australian asset[3]

In their joint judgement in *CIC Insurance Ltd v Bankstown Football Club*, Brennan CJ, Dawson, Toohey and Gummow JJ[4] instanced two common law uses of extrinsic material in interpreting the meaning of words used in legislation:

- To assist with establishing the state of the law before the enactment of the legislation; and
- To discover the mischief intended to be remedied.

[1] Draft Taxation Ruling TR 2024/D3, paragraph 81.
[2] Refer to example 22 of PCG 2024/D3.
[3] Refer to example 13 of TR 2024/D3.
[4] (1997) 187 CLR 384 at [408].

It is also a well established principle that extrinsic materials cannot supplant the text of the legislation. In *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (Northern Territory)*[5] Hayne, Heydon, Crennan and Kiefel JJ observed:

> "This Court has stated on many occasions that the task of statutory interpretation must begin with a consideration of the text itself…. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text…. The language which has actually been employed in the text of legislation is the surest guide to legislative intention…. The meaning of the text may require consideration of the context, which includes the general purpose and policy of a provision …, in particular the mischief … it is seeking to remedy."[6]

Furthermore, the context includes not just the specific words in question but also the role of the relevant statutory provision within the broader context of the Division in which it operates and the tax legislation itself. The tax legislation needs to be read as a whole in ascertaining the meaning of a particular provision.

In *K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd*[7] Mason J affirmed the significance of its legislative context as follows:

> "..to read the section in isolation from the enactment of which it forms a part is to offend against the cardinal rule of statutory interpretation that requires the words of a statute to be read in their context (*Cooper Brookes (Wollongong) Pty Ltd v FCT* [1981] HCA 26; (1981) 147 CLR 297; 35 ALR 151 at 156–7, 169; *Attorney-General v Prince Ernest Augustus of Hanover* [1957] AC 436 at 461, 473). Problems of legal interpretation are not solved satisfactorily by ritual incantations which emphasise the clarity of meaning which words have when viewed in isolation, divorced from their context. The modern approach to interpretation insists that the context be considered in the first instance, especially in the case of general words, and not merely at some later stage when ambiguity might be thought to arise."

Based on the principles of statutory construction outlined above, the Taskforce submits that the following observations can be made with respect to the contextual matrix underpinning the third party debt test:

[5] [2009] HCA 41 at [47].
[6] See, also, *Saeed v Minister for Immigration and Citizenship* [2010] HCA 23.
[7] [1985] HCA 48.

- The Government had intended to retain the ALDT[8]. However, integrity concerns were raised with the ALDT on the basis that "even with strong transfer pricing rules, issues can still arise in complying with, and administering, the test (i.e., the extent of 'implicit credit support' and the effect that has on an interest rate, the concept of 'notional' or 'hypothesised' entities"[9]
- The third party debt test replaces the ALDT
- 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
- As the debt finance is provided by an independent third party, it is assumed to satisfy arm's length conditions
- The test is therefore intended to be a simpler and more streamlined test to apply and administer than the former ALDT, which operated based on valuation metrics and the 'hypothesised entity comparison'
- The third party debt test is designed to be narrow but it is intended to accommodate genuine commercial arrangements relating only to Australian business operations
- It is not so narrow that genuine commercial arrangements are to be unduly impeded or precluded.

The legislative context is as follows:

- The third party debt test is intended to be applied by all general class investors. It is not intended to be limited to inward investing entities only
- Section 820-37, which also forms part of Division 820 provides a definition for the term "average Australian assets". Section 820-680 further prescribes that "for the purposes of this Division [820], an entity must comply with the accounting standards in determining . . . its assets"[10]. It would therefore be surprising if the meaning of the words were to be different between two provisions in the same Division, that are intended to operate in conjunction and harmoniously. The term "Australian asset" must have the same meaning when it is to

[8] Refer to the Labor Party's election manifesto which included a commitment to "maintaining the arm's length test", *Statement of Labor's Economic Plan and Budget Strategy*, page 10.
[9] Government election commitments: Multinational tax integrity and enhanced tax transparency, Consultation paper, August 2022, page 9.
[10] Subsection 820-680(1), *Income Tax Assessment Act 1997.*

be used in determining whether or not thin capitalisation provisions are enlivened (i.e. under section 820-37) and for when it is used to determine the quantum of any impact under the thin capitalisation provisions (i.e. under section 820-427A)

- The meaning of Australian asset must be read within the context of section 820-427A(3), which is intended to provide a debt deduction for genuine commercial arrangements relating to Australian business operations.

From the above, it is evident that the purpose and intent of the third party debt test is to replicate an objective streamlined credit assessment that a third party lender would consider when providing debt to an entity. At paragraph 93 of TR 2024/D3, the ATO connotes that an "Australian asset" will not arise where there is "a connection with a foreign jurisdiction which . . . is more than tenuous or remote". The Taskforce respectfully submits that the ATO's interpretation of this definition for "Australian assets" creates ambiguity and uncertainty both in the application and administration of the TPDT.

Accordingly, it is recommended that the ATO's interpretation of "Australian assets" removes this subjective element of not requiring a connection to a foreign jurisdiction to be more than tenuous or remote. This interpretation approach would revert it to the commonly accepted definition of an Australian asset and make it consistent with the analogous term in section 820-37 (which is guided by the rules in section 820-680).

3. What is "minor or insignificant" for the purposes of applying the third party debt conditions in section 820-427A?

The ATO is of the view that minor or insignificant assets means assets of minimal or nominal absolute value. The ATO opines through examples 8 to 10 in TR 2024/D3 that the actual or hypothetical impact on the debt interest is not determinative, and neither is the value of the assets relative to all of the assets.

PCG 2024/D3 elaborates on this view by indicating that the ATO regards "nominal" value to be the lesser of A$1 million or one per cent of an entity's total assets (noting that the latter percentage itself is a "relative" value by fact that it is judged based on the entity's total assets).

The Taskforce respectfully submits that this is an overly narrow construction of the phrase "minor or insignificant" and is inconsistent with the intent set out in the Explanatory Memorandum:

> "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"[11]

Furthermore, it is observed that the ATO's "brightline" interpretation of the definition of "minor or insignificant" is itself inconsistent with other guidance provided in PCG 2024/D3 and TR 2024/D3. The ATO should reconsider its approach to this definition on the basis that the phrase does not require an absolute value to determine whether an asset is "minor or insignificant"; instead, it needs to be interpreted through the lens of an external creditor relying on objective data points (like credit metrics, existing indebtedness, cash flows, industry volatility, etc) to determine whether that creditor perceives an asset as minor or insignificant in the context of its recourse against an entity.

Definition of minor or insignificant

As the words "minor" or "insignificant" are not defined in the legislation, the ordinary definition of these words should prevail[12]. The Macquarie Dictionary defines the word 'minor' as:

> "lesser, as in size, extent, or importance, or being the lesser of two"

Relevant ordinary meanings contained within the Macquarie Dictionary of 'insignificant', where used as an adjective, include the following:

1. unimportant, trifling, or petty, as things, matters, details, etc.
2. too small to be important: an insignificant sum.

Both adjectives, where used in relation to intangible concepts, require an objective determination of when a particular object is minor and insignificant from the perspective of a creditor. This suggests that in determining whether to regard something as minor or insignificant, an assessment must be made of the appropriate perspective from which to make a decision as to the minor or insignificant nature.

It should be noted that the legislation uses the phrase "minor or insignificant". This suggests that the interpretation should be viewed more broadly than "minor and insignificant", and that if one can ascertain that an asset is minor or insignificant that the other aspect does not need to be tested. It is sufficient that either the asset is minor or that the asset is insignificant. Further, it is evident from

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[11] Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 2.90.
[12] See, e.g., *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue (Northern Territory)* (2009) 239 CLR 27 at [48] – [48].

the accompanying Explanatory Memorandum that there must be some consideration of relativity from the perspective of the debt holder (i.e. the lender).

> "determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature."[13]

Minor and insignificant – to whom?

In applying the subjective analysis of what assets are minor or insignificant for the purpose of section 820-427A(3)(c), it is critical to ascertain the appropriate lens from which to apply the determination. It is noteworthy that the Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023 (Cth) includes the following remarks as to the purpose of the third party debt test:

> "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**" (emphasis added)

The purpose of the operation of the third party debt test can therefore be interpreted as determining the creditworthiness of a borrower by reference to what an independent commercial lender determines that borrower's cash flows can support. As such, the question of whether an asset is minor or insignificant should be interpreted from the perspective of an independent commercial lender.

For completeness, the construction of paragraph 820-427A(3)(c) requires consideration of the entire paragraph. Paragraph 820-427A(3)(c) is focused on the "holder" of the debt interest and the assets that are available to the holder. "Disregarding" recourse to minor or insignificant assets must therefore be viewed from the perspective of the holder of the debt interest.

It would seem perplexing if an asset that has no bearing on an entity's credit worthiness and disregarded by the lender in terms of its credit assessment – could preclude the utilisation of the third party debt test. In particular, as 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**" (emphasis added).

[13] Supplementary Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 1.30.

Accordingly, the construction of the words "minor or insignificant" must be viewed from the perspective of the lender, having regard to that lender's ultimate aim of having its investment repaid. It is not intended to connote an absolute or nominal basis.

Not a de minimis measure

Within the context of the drafting of the final bill, it is crucial to note that the first iteration of the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 did not contain a carve out for minor or significant assets.

In light of the submissions recognised by the Senate Economics Legislation Committee and the Committee's ensuing recommendations, technical amendments were made to the Bill in its subsequent iteration. This had the effect of updating the wording of the then-proposed paragraph 820-427A(3)(c) to its ultimately legislated form, being:

> "(c) disregarding recourse to minor or insignificant assets, the holder of the debt interest has recourse for payment of the debt to which the debt interest relates only to Australian assets that:
>
> > (i) are covered by subsection (4); and
> >
> > (ii) are not rights covered by subsection (5) (about credit support rights);"

Relevantly, the Supplementary Explanatory Memorandum to this version of the Bill stated the following, providing context as to the purpose and operation of the concession inherent in the new drafting:

> "1.30 Recourse to minor and insignificant ineligible assets (i.e., assets which are not mentioned in the paragraph immediately above, such as an asset which is not an Australian assets) is disregarded. This allowance is intended to prevent paragraph 820-427A(3)(c) being contravened for inadvertent and superficial reasons. **Determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which <u>recourse for payment of the debt can be had</u> and whether those ineligible assets are of a minor and insignificant nature**" (emphasis added)

Given the context of this amendment was brought about via the Senate Economics Legislation Committee's consultation process, it is apparent that the inclusion of "minor or insignificant" assets was a concession intended to enable taxpayers to minimal or insignificant non-Australian assets and still be able to satisfy the test.

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Specifically, it is noted that the ATO considers the interpretation requires a “brightline” test such that the value of assets should be no more than $1 million or one per cent of the entity’s total assets based on its guidance in paragraph 245 of PCG 2024/D3.

The Taskforce submits that this type of approach is not intended by the Legislature.

For example, section 820-35, which has not been affected by the amended thin capitalisation provisions, provides an explicit $2 million threshold for determining whether or not an entity is subject to parts of Division 820.

By contrast, the Legislature has specifically chosen language which inherently imputes an element of relativity; the words “minor or insignificant” is not language which obviates the need for a subjective determination. Accordingly, it is respectfully submitted that the ATO’s view that this phrase is intended to apply for “minimal or nominal value” is incorrect because if the intent was to be an absolute value objective measure, the Legislature would have specified as such (e.g. by using an exact value).

Proposed interpretation

Based on the above, it is proposed that the correct interpretation of “minor or insignificant” for the purposes of section 820-427A requires an assessment of whether an external debt holder would perceive the assets to be material or significant for the purposes of recovering its investment, when relying on objective measures and empirical data.

The test should be applied from the creditor’s point of view.

In light of the history of this legislation, and the absence of a specific quantum from the Legislature, this interpretation appears to be the only approach that reflects Parliament’s intent.

4. Whether debt interests used to fund distributions and capital management activities should be considered to fund commercial activities for the purposes of section 820-427A(3)(d)

The ATO’s view of “commercial activities in connection with Australia” is that it is designed to cover debt used to fund investment in the Australian operations of trade or business capable of generating a profit, with examples of activities that do not meet that description being the payment of distributions, capital management activities, or the indirect purchase of foreign assets through an Australian entity (paragraph 107).

The ATO's interpretation appears to take a narrower view of the term "commercial activities in connection to Australia" than what may be supported by a plain reading of the legislative provisions in their appropriate context and by reference to established judicial consideration in analogous situations. For example, we refer to Gordon J's summary of the concept of a commercial transaction in *Visy Industries USA Pty Ltd* v *FC of T* [2011] FCA 1065:

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

In this context, the payment of financing costs, capital management and the payment of distributions by an entity carrying on an activity should clearly be considered as occurring in the ordinary course of, or as an incident of, carrying on that activity. To the extent that activity carried on comprises solely Australian operations any debt interest obtained to finance that activity should be considered to solely fund its commercial activities in connection with Australia.

The ATO notes that the expression "commercial activities in connection with Australia" is not defined, and therefore takes on its ordinary meaning in the context it appears (paragraph 104). The ordinary meaning of 'commercial' and 'activity' in the context of trade or business referenced paragraph 105 may be appropriate in an isolated context, however this results is an overly narrow reading of 'activity' in the context of the TPDT rules and its objectives. This is because the ATO appears to be focused on activities that can return a profit, rather than activities undertaken as part of a trade or business that can return a profit. In this regard, the Taskforce notes paragraph 107 which acknowledges that "s820-427A(3)(d) is designed to cover third party debt that is used to fund investment in the Australian operations of trade or business capable of generating profit" but then focuses on specific "activities that do not meet that description" and thus it considers will not satisfy section 820-427A(3)(d).

From a commercial point of view, it is simply a reality of trade or business that certain activities that are necessary aspects of that trade or business are not, in and of themselves, capable of returning a profit. Such activities could also conceptually include projects or activities which are undertaken by an entity for broader strategic reasons notwithstanding there being no prospect of a profit arising from that particular activity. Moreover, an entity may conduct a commercial activity that overall is not anticipated to make a profit but nonetheless serves a commercial purpose within the context of the broader group. A relevant example in this context are the financing arrangements entered into by a special purpose financing entity seeking to meet the conduit financing requirements which requires costs to be passed through on a back-to-back no margin basis. The ATO position would appear to call into question whether the special purpose financing company is carrying on a "commercial activity" which is at odds with the overall intent of the TPDT and the conduit financing rules in particular.

It is impossible to bifurcate the 'Australian operations of trade or business' from the inherent 'capital management activities' of that trade or business – i.e. an entity cannot carry on business without at least occasionally paying distributions or raising debt or equity, (or more broadly, undertaking activities which may not in isolation generate a profit). In this sense, any activity necessary in the course of trade or business is inherently a 'commercial activity', particularly in the context of the TPDT which is specifically "to accommodate genuine commercial arrangements relating only to Australian business operation" (per paragraph 2.92 of the EM), and whether a specific activity can generate a profit should not be a relevant consideration.

The above point is particularly relevant when considering the ATO's guidance at paragraph 106: "It [TPDT] operates principally to accommodate capital intensive sectors with long investment horizons, such as the property and infrastructure sectors. The expression 'commercial activities in connection with Australia' should be construed in that context". By taking the narrow view, the Taskforce respectfully submits the considerations relevant to infrastructure businesses (e.g. capex construction timeframes, differing funding requirements through the lifecycle, the recycling of equity and debt from project to project (capital management generally) etc) have not been taken into account. The narrow approach ultimately precludes the TPDT from being applicable to the very taxpayers the rules were intended to accommodate.

In addition to the above, the narrow interpretation of the term "commercial activities in connection with Australia" appears inconsistent with the intent of the Legislature when the provision was being drafted. In this regard, it is important to note that the initial drafting of this issue in the Exposure Draft[14] contained the following requirement in section 820-61:

> **820-61 Meaning of *external third party earnings limit* and *external third-party debt conditions***
>
> (1) An entity's ***external third party earnings limit*** for an income year is the sum of each *debt deduction of the entity for the income year that is attributable to a *debt interest issued by the entity that satisfies the *external third-party debt conditions in relation to the income year.
>
> (2) A *debt interest issued by an entity satisfies the ***external third-party debt conditions*** in relation to an income year if the following conditions are satisfied:
>
> (a) the entity issued the debt interest to an entity that is not an *associate entity (see subsection (9)) of the entity; and
>
> (b) the debt interest is not held at any time in the income year by an entity that is an associate entity of the entity;
>
> (c) the holder of the debt interest has recourse for payment of the debt only to the assets of the entity;
>
> (d) the entity uses the proceeds of issuing the debt interest wholly to fund its investments covered by subsection (3) and its Australian operations.
>
> (3) This subsection covers investments that relate only to:
>
> (a) assets that are attributable to the entity's *Australian permanent establishments; or
>
> (b) assets that the entity holds for the purposes of producing assessable income.

The Taskforce made a submission to Treasury dated 13 April 2023 that the condition in paragraph 820-61(2)(d) was too narrow and proposed the following drafting changes which were accepted and reflected in the provisions ultimately legislated:

[14] Exposure Draft for the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation*.

Issue 7A – ETPDT conditions – "wholly to fund" requirement

Issue:

- The *external third party debt conditions* can only be satisfied by debt issuances where the proceeds from the debt issuance are used **wholly** to fund certain investments (in particular, assets that the entity holds for the purposes of producing assessable income or assets that are attributable to an entity's permanent establishments) - paragraph 820-61(2)(d).
- This may preclude an entity from satisfying the external third party debt conditions where some or all of the proceeds from the debt issuance is used to:
  - Re-gear an asset (i.e. where the proceeds replace equity). For example, for an infrastructure asset in a greenfield stage, the shareholders may choose to fund the construction of the assets by way of equity which may subsequently be replaced with bank debt upon the asset becoming income producing;
  - To fund the payment of expenses (for example, Bank Fees) or liabilities; or
  - To fund non-income producing assets. Infrastructure projects typically involve the construction of both income producing assets and non-income producing assets, such as community infrastructure associated with the project. For example, a toll-road project may involve the construction of a toll road (which is income producing) and an associated bus lane (which is not income producing).

Proposed amendment:

- We respectfully submit that given that a debt deduction would be required to satisfy ordinary principles (s 8-1 / s 230-15) in addition to thin capitalisation, it appears unclear what this condition seeks to achieve.
- If the integrity concern is to ensure that funds are not used offshore, we propose that section 820-61(2)(d) can be drafted in the negative – i.e., the entity does not use the proceeds to fund, to any extent, its non-Australian operations or to derive non-assessable non-exempt income.

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From a policy perspective borrowing to repay (via a capital reduction / return of capital) contributed equity previously used to fund commercial activities in connection with Australia should not fall foul of this requirement (i.e. the ATO view in this regard is inconsistent with its views regarding the need for tracing to be applied when the proceeds of a debt issuance are used to fund assets which are subsequently disposed of).

Relevance of previous guidance on the ALDT

The draft guidance does not appear to acknowledge that the term "commercial activities in connection with Australia" is exactly the same as that used in the former ALDT provisions (former section 820-105(2)(a)) and does not refer to the previous guidance provided in respect of those provisions. This is notwithstanding that the TPDT is intended to operate as "a credit assessment test, in which an independent commercial lender determines the level and structure of debt finance it is prepared to provide to an entity" (per paragraph 2.90 of the EM) and to "accommodate genuine commercial arrangements relating only to Australian business operation" (per paragraph 2.92 of the EM); this is principally the same objective of the former ALDT which was to "establish the notional amount of debt that the entity would reasonably be expected to have held… and that independent commercial lenders would have provided" (paragraph 10.14 of the Former Thin Cap EM) in respect of the taxpayer's "Australian operations, when viewed independently from the foreign operations" (paragraph 10.3 of the Former Thin Cap EM).

That the TPDT is deliberately more restrictive than the former ALDT (insofar as the latter is based on a notional assessment taking into account certain 'factual assumptions' and 'relevant factors', whereas the former is based on actual conditions/circumstances in existence during an income year), is acknowledged, but in principle, the conditions/circumstances required of a taxpayer under the TPDT should be aligned to the notional assessment required to be made by a taxpayer under the former ALDT (and vice versa).

In this regard, the relevant guidance in respect of the expression "commercial activities in connection with Australia" as that term is used in the TPDT should include reference to the same expression in the former ALDT (and not rely, as the ATO has done, on the dictionary definitions in an isolated context).

Former section 820-105(2) operated to "establish a scenario that would have existed if the entity's Australian operations were independent from any other operations that the entity" (per paragraph 10.11 of the Former Thin Cap EM[15]). This is principally the same objective as the TPDT being limited to "commercial arrangements relating only to Australian business operation" (per paragraph 2.92 of the EM). Accordingly, the appropriate interpretation of 'commercial activities in connection with Australia' for the purposes of the TPDT should be consistent with that which applied under the former ALDT, in order to achieve the policy objectives of the TPDT.

The Taskforce respectfully submits the approach adopted in the draft guidance creates an unnecessary evaluation (and uncertainty and complexity) of already well established concepts in tax law, introduces an artificial bifurcation of specific business activities from the business itself, and imposes a further restriction of the TPDT which was not legislated, nor contemplated or intended by Parliament.

ATO interpretation attempts to introduce DDCR concepts into the TPDT

By excluding the funding of capital management activities and distributions from the scope of "commercial activities", the ATO is attempting to replicate a key element of DDCR within the TPDT[16]. If the Commissioner's arguments were correct, it would seem unusual that the legislature would introduce a specific anti-avoidance measure (section 820-423A(5)),provide an exemption for entities that have chosen the TPDT from the anti-avoidance rule (subsection 820-423A(5)(f)) but then seek to imply within the TPDT itself elements of the DDCR.

[15] Explanatory Memorandum to New Business Tax System (Thin Capitalisation) Bill 2001
[16] However, the impact of this is even more significant in the context of the TPDT as a breach of the requirements would deny all debt deductions arising under the debt interest rather than just the debt deductions relating arising from the impermissible use of the borrowed funds.

The replication of DDCR within the TPDT also appears at odds with a general principle of statutory construction that holds that where a particular procedure is designed to achieve something specific, other more general procedures that seek to achieve the same end are thereby excluded. In this case where a specific statutory provision, such as the DDCR, regulates the use of debt funding to pay distributions (as well as other capital management strategies), interpreting a more general provision such as the TPDT to achieve the same end should be disregarded. This principle of statutory construction is given colour by the Latin maxim – e*xpressum facit cessare tacitum*.

In *Anthony Horden and Sons Ltd v The Amalgamated Clothing and Allied Trades Union of Australia* (1932) 47 CLR 1 at 7, Gavan Duffy CJ and Dixon J said:

> "*When the Legislature explicitly gives a power by a particular provision which prescribes the mode in which it shall be exercised and the conditions and restrictions which must be observed, it excludes the operation of general expressions in the same instrument which might otherwise have been relied upon for the same power."*

In *R v Wallis; Ex parte Employers Association of Wool Selling Brokers* (1949) 78 CLR 529 Dixon J said at 550:

> *"An enactment in affirmative words appointing a course of action to be followed usually may be understood as importing a negative, namely, that the same matter is not to be done according to some other course'.*

In *John v Commissioner of Taxation* (1989) 166 CLR 417, the High Court rejected the principle of fiscal nullity (i.e. a doctrine developed in the UK which enabled courts applying revenue legislation to ignore steps of transactions that were pre-ordained and no commercial purpose than avoiding tax) on the basis that Australia had a GAAR. As Australia had a GAAR, there was no place for a more general doctrine of fiscal nullity.

The High Court said:

> If any such or similar principle is to be applied in relation to the Act, it is one that must be capable of implication consonant with the general rules of statutory construction. One such general rule, expressed in the maxim ***expressum facit cessare tacitum***, is that where there is specific statutory provision on a topic there is no room for implication of any further matter on that same topic. The Act, in s.260 and now in Part IVA, makes specific provision on the topic of what may be called tax minimisation arrangements and thereby excludes any implication of a further limitation upon that which a taxpayer may or may not do for the

purpose of obtaining a taxation advantage. We would respectfully adopt as correct that which was said by Gibbs J. in Patcorp (at p 292):

"The presence of s.260 makes it impossible to place upon other provisions of the Act a qualification which they do not express, for the purpose of inhibiting tax avoidance."

The existence of a specific rule, i.e. the DDCR, would seem to preclude the importation of similar concepts into the TPDT.

Practical considerations and related issues

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

It is also unclear whether the ATO's view is that a failure of this requirement in one year taints the debt for its life (i.e. disallowing deductions in any income year) – the Taskforce respectfully submits that this needs to be clarified (including in respect of prior income years).

If the ATO is to maintain their view, it is unclear how debt used to refinance existing debt is to be treated. It would be unreasonable (for example), to disallow debt deductions on a debt issued today which was used to repay a debt used historically in a way that that the ATO now considers does not fund its commercial activities in connection with Australia (and perhaps this could be dealt with in PCG 2024/D3 as a compliance approach as a minimum). However, a debt refinance should generally be considered to be to fund a taxpayer's commercial activities in connection with Australia.

The term capital management is not used in the legislation and if the ATO maintains its view, clarification is needed regarding the scope of what constitutes capital management for these purposes. For example, does capital management include refinancing a construction loan (and capitalised interest) with a term facility once a development asset commences operations. Would the position be the same if some of the term facility was used to return capital to investors. If not, how can any difference in treatment be reconciled by reference to the "commercial activity" test. How does the ATO reconcile the 'refinancing principle' adopted in the *Roberts & Smith case* in these circumstances. Apart from the capital flows themselves, would the costs of raising equity, raising debt, returning capital, buybacks and IPO's be considered capital management for these purposes. That such issues are unclear suggests that the position is not supported by interpretation of the legislation nor the explanatory memorandum.

These issues are particularly salient in an infrastructure project where project finance is often not available from financiers until various development and/or operational milestones are met. In this regard, it is simply not commercially viable for third party debt to be ineligible for third party debt test treatment only because the third party debt replaces development equity from the project sponsors.

Having regard to the above, the Taskforce respectfully submits the following amendments to the draft guidance:

i) Include a reference to the expression "commercial activities in connection with Australia" as used in the former ALDT provision as being relevant context to the application of that same expression in the TPDT (with the same policy intent)

ii) Remove the paragraph the last sentence in paragraph 107: "The use of the proceeds of issuing the debt interest to fund activities that do not meet that description (for example, the payment of distributions, capital management activities, or the indirect purchase of foreign assets through an Australian entity) will not satisfy paragraph 820-427A(3)(d)"

iii) Remove Example 16 (paragraphs 111 and 112).

5. Conduit Financing rules – need for guidance on the treatment of on-swaps

The inclusion of Example 1 in TR 2024/D3 and the conclusion reached on the non-deductibility of the on-swap has created significant confusion in the market with regards to the application of how hedging costs such as interest and cross currency interest rate swaps interact with the third party debt test conditions. Typically, the use of a financing company would occur where the entities are seeking to rely on the Conduit Financing rules, as such if the example is to remain in the tax ruling, then it would be helpful to provide some comments on how the Conduit Financing rules would apply to the on-swap agreement.

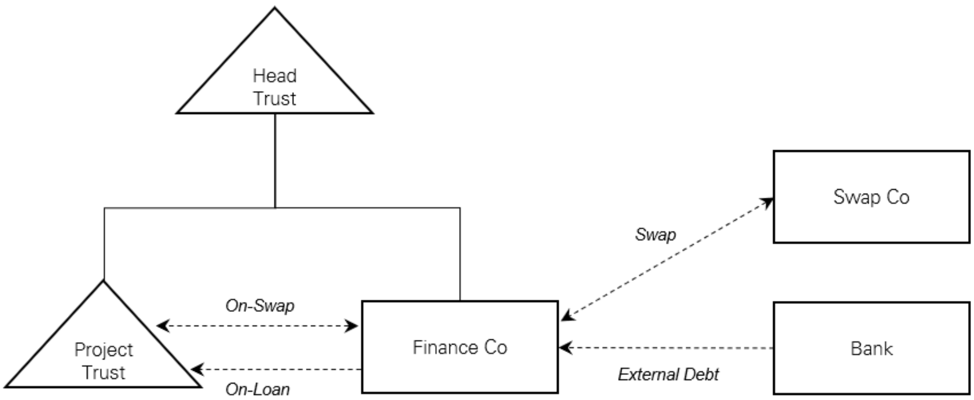
The Taskforce notes that in PCG 2024/D3, the Commissioner seeks to provide examples of restructures that are considered to be low risk restructures, which includes Example 26 where the on-swap agreement between Finance Co and Project Trust is restructured to be embedded into the on-loan agreement.

In both of these examples the taxpayer would be looking to avail itself of the Conduit Financing rules in order to be compliant with the third party debt test conditions. However, neither of these examples specifically confirm that the structures outlined in them would satisfy the Conduit Financing Conditions set out in section 820–427C. Paragraph 7 of TR 2024/D3 even specifically confirms that consideration of the Conduit Financing rules is outside the scope of the ruling which makes the inclusion of these examples somewhat confusing.

The Taskforce considers that providing certainty on the treatment of hedging costs in the context of the Conduit Financing rules is critical as hedging is an essential requirement of many infrastructure projects and there is currently considerable uncertainty in how the rules apply.

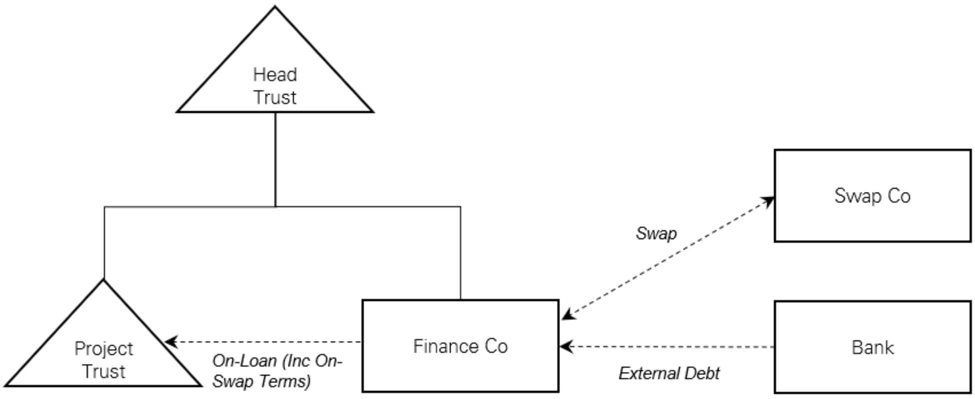
In general, there are two very similar structures that are commonly used by infrastructure projects to pass on hedging costs such as interest rate swaps and examples of these are summarised and illustrated diagrammatically below:

- *Example 1 – Separate on-swap and on-loan*



Finance Co borrows from Bank and on-lends the proceeds (on the same terms) to Project Trust to fund the creation and development of an Australian infrastructure project. Separately, Finance Co enters into an interest rate swap with Swap Co to hedge the interest risk on the External Debt. Finance Co and Project Trust enter into an On-Swap which is on back-to-back terms. Finance Co is in a net zero profit position.

- *Example 2 – Swap included in terms of on-loan*



Finance Co borrows from Bank and on-lends the proceeds (on the same terms) to Project Trust to fund the creation and development of an Australian infrastructure project. Separately, Finance Co enters into an interest rate swap with Swap Co to hedge the interest risk on the External Debt. The terms of the On-Loan are such that they incorporate terms of the interest swap entered with Swap Co such that Finance Co is in a net zero profit position.

Despite the fact that both of the above examples give the same economic outcomes, there is considerable uncertainty in how they should be treated for tax purposes as the legislation potentially restricts the deductions being taken on both types of arrangements, albeit for different reasons which are outlined below:

- Example 1 - Separate on-swap and on-loan
    - Subsection 820-427A(1) confirms that an entity's third party earnings limit only includes debt deductions that are "*attributable to a debt interest issued by the entity that satisfies the third party debt conditions in relation to an income year*".
    - While a swap by itself would not meet the definition of a "debt interest" (noting that Subsection 974-15(6) specifically precludes a swap from being part of a debt interest), Subsection 820-427A(2)(a) allows a debt deduction that "is directly associated with hedging or managing the interest rate risk" of a debt interest to be attributed to that debt interest.
    - Prima facie, this is intended to allow a deduction for interest rate swap payments where the associated debt interest being hedged meets the third party debt conditions.

- However, subsection 820-427A(2)(b) confirms that this attribution does not apply where the debt deduction is referrable to an amount paid, directly or indirectly, to an Associate Entity.
- Importantly, Subsection 820-427A(2)(b) is not modified by the application of the Conduit Financing provisions in section 820-427B which appears to be a drafting oversight as the intention of the Conduit Financing rules was clearly to include interest rate on-swaps within the third party earnings limit.

  The Bill initially provided protection from the operation of non-associate entity requirement in section 820-427A(2) for conduit financing arrangements through section 820-427B(2) which was later removed when that subsection was rewritten.

  Subsection 820-427B(2) was initially drafted such that payments under an on-loan and on-swap that satisfied the conduit financing conditions would be deductible as they were deemed to satisfy the test in subsection 820-427A(2).[17]

  The Supplementary Explanatory Memorandum at paragraph 1.25 does not explain the reason for the withdrawal of the protection in section 820-427B(2). However, it further expressed the view at paragraphs 1.25 and 1.26 that conduit financing arrangements involving swaps should be effective:

  - *"1.25: An interest rate swap cost that relates to multiple debt interests is now generally deductible under the third party debt test, to the extent subsection 820-427A(2) is satisfied in relation to the cost."*
  - *"1.26: 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'."*
- In our view Subsection 820-427A(2)(b) should be interpreted to mean "paid ultimately to an associate entity" such that deductions for payments under an on-swap (including the payment of a swap gain Finance Co has derived on the external swap to Project Trust) are allowed where the swap payment is ultimately referable to swap payment made with a third party as that is clearly within the intention of the rules.

[17] Refer also to the original Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 2.108.

- <u>Example 2 – Swap included in terms of on-loan</u>
    - While this example is clearly not restricted by subsection 820-427A(2)(b) in the same way as Example 1, there are potential issues with the interpretation of subsection 820-427C(2)(d) and subsection 820-427A(1).
    - This subsection states that the taxpayer should "*disregard the terms of the* [On-Loan] *to the extent that those terms have the effect of allowing the recovery of costs of the* [Finance Co] *that: (i) are <u>a debt deduction</u> for the income year of* [Finance Co]; *and (ii) are a debt deduction that is treated as being attributable to the ultimate debt interest under subsection 820-427A(2) because it is directly associated with hedging or managing the interest rate risk in respect of the* [External Debt]".
    - Specifically, where Finance Co makes a gain on the external interest rate swap (i.e. if it is in-the-money) it would have no costs to recover under this subsection and reading the wording literally the swap gain amounts cannot be disregarded as they are not "debt deductions" (because they are actually income) and therefore the External Debt and On-Loan could be viewed as being on different terms. Further, under a literal interpretation of section 820-427A(1), the payment of a swap gain by Finance Co to Project Trust is a not deduction of Finance Co that is attributable to a debt interest issued by Finance Co and therefore, is not included in Finance Co's third party earnings limit.
    - Again, this appears to be a drafting oversight as the intention of subsection 820-427C(2)(d) was clearly to allow the terms of interest rate swaps to be incorporated within the terms of the On-Loan without failing the rules.
    - Our view is that subsection 820-427C(2)(d) and 820-427A(1) should be read such that the debt deduction referred to is the total costs being recovered by Finance Co (i.e. the net of the swap gains and losses and the external debt) rather than costs specifically of the swap.

Given the complexities above, the Taskforce believes it to be critical for the ATO to issue guidance specifically confirming how these rules should be interpreted. As it stands, because of the lack of clarity in the legislation, taxpayers are being forced to choose which option to use without clarity on which option is actually compliant with the rules.

Example 1 in TR 2024/D3 could be interpreted as indicating that an on-swap agreement which is in legal form separate from the on-loan agreement fails the third party debt test conditions. Conversely, Example 26 in PCG 2024/D3 indicates that embedding the terms of on-swap within the terms of the on-loan is acceptable. However, the example does not address any of the interpretational issues outlined above which has caused considerable confusion in the market.

Our view is that a substance over form approach is more appropriate given that the economic outcome of both options is exactly the same. As such, the Taskforce considers that guidance should be issued confirming that both options are compliant with the rules as it would seem very arbitrary for one approach to be acceptable and the other not when they economically come to the exact same outcome.

Accepting one approach as compliant, but not the other, would simply force taxpayers to restructure to the approach that is deemed compliant. This would be an unnecessary burden without any increase in tax revenue collected so would seem to be an unwarranted position to take (particularly given that the ATO has already confirmed in Example 26 in PCG 2024/D3 that restructuring to be compliant with the rules should not be the subject of compliance activity).

6. Section 820-427A(2) – need for guidance on the bifurcation of hedging costs under combined interest rate cross currency swaps.

Regardless of the position reached above with regards to the compliant methods for passing on swap costs through conduit companies, the Taskforce considers it necessary for the ATO to clarify the acceptable methods for the bifurcation of combined interest rate and cross currency swap arrangements.

In situations where there is a separate on-swap arrangement between a Finance Co and Project Trust (such as Example 1 above – assuming that the situation in the example is deemed to be compliant), this will be necessary to determine how much of the combined swap costs can be treated as deductible under section 820-427A(2).

However, even if Example 1 above is deemed not to be compliant, guidance on the bifurcation of interest and cross currency swap arrangements will still be necessary for determining the quantum of costs subject to the thin capitalisation rules versus those that are not (which would be relevant in applying the Fixed Ratio Test if nothing else). This is because based on an ordinary reading of the legislation, cross currency swaps do not meet the definition of a debt deduction under section 820-40 and unlike interest rate swaps there is no mention of them being included in the explanatory memorandum or legislation.

7. Characterisation of recourse to assets comprising contingent rights that only arise in the event of a failure to perform (e.g. failure to contribute equity, failure to make lease payments, failure to deliver contracted services).

Broadly, the recourse condition in section 820-427A(3)(c) under the third party debt test requires the holder of the debt interest to have ***recourse for payment of the debt*** to which the debt interest relates only to Australian ***assets*** that are covered by subsection 820-427A(4) and are not ***rights under or in relation to a guarantee, security or other form of credit support*** covered by subsection 820-427A(5). That is, the thing to which the lender has recourse must:

1. Be recourse for payment of the debt;
2. Be an asset; and
3. If that asset is in the form of a right under or in relation to a guarantee, security or other form of credit support, then that right must not be covered by Subsection 820-427A(5).

In the Commissioner's view, the expression "recourse for payment of the debt" refers to the lender's ability to recover amounts owed to it by the borrower[18] . In assessing the question of whether a lender has recourse for payment of debt, the Commissioner considers that the "focus of the enquiry is on the assets available in satisfaction or recovery of amounts owed to the holder of the debt interest, such as in the event of default. It is the assets themselves that are relevant, not, for example, the cash proceeds of any actual or hypothetical liquidation of them."[19]

As stated above, the word "asset" is not legislatively defined for the purposes of section 820-427A(3)(c) and, as such, takes on its ordinary meaning. The Macquarie Dictionary defines "asset" to mean:

> "something that has value and is owned, or controlled, by a person, business or organisation"[20]

In the context of arm's length commercial arrangements for the acquisition of goods or services, there may be terms in the contract which provide the acquirer of the goods or services with performance guarantees. These terms typically involve obligations arising for a related party (**guarantor**) of the provider of the goods or services (**provider**) upon a failure by the provider to perform their obligations under the contract (i.e. a breach of contract). This type of guarantee stems from contract law principles where the only remedy for default by a party is specific performance, on the basis that no other form of damages would adequately rectify the breach.[21] Accordingly, these contractual arrangements ordinarily have nothing to do with an entity's ability to obtain finance, but instead are present to provide equitable remedies for breach of contract.

[18] TR 2024/D3, paragraph 36.
[19] TR 2024/D3, paragraph 39.
[20] Macquarie Dictionary (online ed.).
[21] *Dougan v Ley & Anor* (1946) 71 CLR 142, 150 per Dixon J.

Where these specific performance obligations arise for the guarantor, the acquirer of the goods or services has a contractual right to enforce the performance of those obligations against the guarantor. This enforceable contractual right is contingent on the failure to perform on the part of the provider and only arises at that time – this is well documented in case law.[22] In the absence of such failure, the acquirer has no such presently enforceable right against the guarantor. The following are common examples of performance guarantees in the infrastructure sector:

- Design and construction contractors may issue performance bonds or parent guarantees to an infrastructure entity in support of their obligation to design and construct the project – this would be based on the fact that the contracts are multi-billion dollar projects with limited other providers capable of delivering the requirements of that project;
- Operations and management contractors may issue performance bonds or parent guarantees to an infrastructure entity in support of their obligation to operate and maintain the project – again, this is based on the fact that the operation and maintenance of certain infrastructure requires specialist expertise which not every contractor would be capable of performing; and
- An offtaker may enter into a power purchase agreement in respect of the electricity generated by the project which may be supported by guarantees – this is primarily due to the specific nature of the offtake agreements which makes it difficult for another party to readily take over the agreement on the same terms.

Due to the unique nature of infrastructure projects, performance guarantees provide an extra level of contractual protection to ensure that critical infrastructure is able to continue to operate effectively, or the construction of the project is able to continue to be carried out in the event of non-performance by a third party to deliver or acquire goods or services. The purpose of the performance guarantee is not to secure a greater level of debt from a third-party lender than would otherwise be the case in the absence of such a guarantee; rather it is based on the equitable doctrine of specific performance to provide the procurer with a contractual remedy that is fit for purpose. Put another way, these types of guarantees are incorporated into contracts between two commercial parties to obtain certainty over their equitable rights at common law.

Relevant to the third party debt test, when a potential lender in assessing the amount of debt that it is willing to lend to a potential borrower, the potential lender typically does not have regard to the existence of any such guarantee.

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[22] See, e.g., *Turner v Bladin* (1951) 82 CLR 463, 472 (Williams, Fullagar and Kitto JJ).

The Taskforce submits that performance guarantees that are contingent on non-performance by a counterparty are not rights that are assets of the borrower for the purposes of section 820-427A(3)(c); rather, they are contractualised equitable remedies that enable the borrower to enforce specific performance for a breach of contract by the counterparty, through enforcement against the guarantor. In the absence of such breach, the borrower has no such presently enforceable right against the guarantor and recovery from the guarantor is merely a hypothetical postulate.

Even if it were the case that performance guarantees that are contingent on non-performance by a counterparty are rights that are assets of the borrower, they would typically not be recognised as an asset under the accounting standards as it is not probable that future economic benefits embodied in the asset will eventuate so long as those guarantees remain contingent. In this regard, the Taskforce submits that section 820-680, which requires an entity to comply with the accounting standards in determining what are its assets and in calculating the value of its assets for the purposes of Division 820, is required to be taken into account in applying Section 820-427A.

Further, it is submitted that the term guarantee, security or other form of credit support must be read in context of subsections 820-427A(3)(c) and 820-427A(5). The relevant guarantee, security or other form of credit support is specifically referable to rights that support the relevant “credit” assessment being contemplated by section 820-427A; the relevant credit assessment being undertaken with respect to the debt interest subject to section 820-427A.

The Taskforce submits that section 820-427A(5) should be interpreted such that only a “guarantee, security or other form of credit support” that supports the relevant credit, namely the debt interest being tested under section 820-427A, should be excluded under section 820-427A(5). Unrelated performance guarantees that are contingent on non-performance by a commercial counterparty that do not support the relevant “credit” are not excluded by virtue of section 820-427A(5).

This view is consistent with the policy set out in the Explanatory Memorandum:

- “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.”[23];
- “Recourse to rights under or in relation to forms of credit support (referred to in the following paragraphs as ‘credit support rights') are generally prohibited to ensure that multinational

[23] Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 2.90.

enterprises do not have an unfettered ability to fund their Australian operations with third party debt."[24]; and

- "The general prohibition on recourse to credit support rights is maintained. The prohibition ensures that multinational groups do not have an unfettered ability to 'debt dump' third party debt in Australia that is recoverable against the global group."[25]

Even if it were the case that performance guarantees that are contingent on non-performance by a counterparty are rights that are assets of the borrower and which support the debt interest being tested under section 820-427A, the Taskforce submits that they should not be regarded as a form of credit support under subsection 820-427A(5) for the reasons set out below.

Footnote 49 to TR 2024/D23 states that the expression 'guarantee, security or credit support' carries the same meaning as in former paragraphs 820-105(2)(e) and 820-215(2)(e) and therefore previous guidance issued by the ATO on the meaning of credit support under the former ALDT remains relevant. This would include TR 2020/4 Income tax: thin capitalisation – the ALDT. However, the guidance in TR2020/4 is broader than what has been contemplated and legislated in the TPDT insofar as both explicit and implicit forms of credit support were included in the former ALDT, whereas the TPDT specifically refers to "rights" (which inherently requires an explicit form of credit support to exist). The draft ruling should be updated to reflect this distinction.

Another example of guidance previously provided by the ATO on the meaning of credit support, at least in the context of a practical compliance guideline, is set out in PCG 2020/7 which states that:

> "The existence of a **commercial arrangement undertaken at arm's length between the notional Australian business and an associate should not necessarily be taken to indicate the existence of credit support**. This will turn on the precise facts but **an example that is considered unlikely to constitute credit support is an offtake agreement for the sale of a commodity**. In contrast, an arrangement entered into for the purpose of facilitating lending from a third-party lender, such as a commitment to deferred equity by a shareholder, is likely to have a sufficient nexus to the provision of financing to constitute credit support." (emphasis added)

In line with that guidance, it is submitted that performance guarantees entered into between the borrower and associates on ordinary commercial terms (such as would exist between third parties)

[24] Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 2.99.
[25] Supplementary Explanatory Memorandum to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, paragraph 1.31.

should not be considered credit support for the purposes of section 820-427A(5). It is acknowledged that this would of course depend on the precise facts. However, it is submitted where the facts are that the performance guarantee can only be called in the event of a failure to perform (rather than, for example, in the event of a default under the financing arrangements) and there is no such performance failure subsisting then the arrangement should not comprise credit support at that time on the basis that the holder of the debt interest does not, at that time, have recourse to the performance guarantee for payment of the debt for the purposes of section 820-427A(3)(c).

The Taskforce respectfully requests that example 6 in TR 2024/D3 be reconsidered in light of the above and that further examples of ordinary commercial arrangements that do not constitute credit support in accordance with the above ATO guidance should be included. Unless this point is clarified in the guidance, taxpayers will be left with arguably contradictory views from the ATO as to whether ordinary commercial arrangements to secure performance under contracts should be considered to constitute credit support.

8. Determining whether rights against a foreign entity (e.g. credit support rights) are Australian assets.

Paragraph 84 of TR 2024/D3 states that:

> "Assets that are rights against foreign-resident entities (for example, credit support rights provided to an Australian entity by a foreign entity) should be carefully considered to determine whether or not they are 'Australian assets'."

Without restating our earlier submissions regarding the meaning of "Australian assets", in this specific case it is submitted that the relevant question is whether the "right" is an Australian asset of the borrower determined from the perspective of that borrower.

As acknowledged by the Commissioner in paragraph 42 of TR 2020/D3:

> "Where the issuer or a member of the obligor group holds assets that are rights against another entity, **those rights themselves are the relevant assets**. Paragraph 820-427A(3)(c) **does not require an entity to 'look-through' those rights to any underlying assets held by the other entity**, or to identify any assets the rights may directly or indirectly provide or allow recourse to."

Therefore, whether the counterparty to that right (which from its perspective would be an obligation) is a foreign resident has no bearing on whether the right itself is an Australian asset of the borrower (or obligor). Rather, the only relevant question is whether the right is used by the borrower (or obligor) in its Australian operations.

It would be illogical to suggest that the residence of the counterparty that had the corresponding obligation in respect of that right had any relevance to that question.

Moreover, the cited example of credit support provided by a foreign resident to a borrower (or obligor) to an Australian resident borrower in respect of a borrowing used to fund its Australian operations should clearly be an Australian asset. Section 820-427A(5) also appears to assume that credit support rights are Australian assets, otherwise there would be no need for the further prohibition on credit support rights provided by a foreign entity that is an associate entity for the purposes of section 820-427A(5)(b).

The Taskforce is concerned that by specifically calling out credit support in this context the ATO may be inferring that where a credit support right provides indirect recourse to the assets of a foreign resident as contemplated by section 820-427A(5)(b) that this somehow may imply that the credit support right itself is not an Australian asset. This is likely to cause unnecessary confusion and contradicts the ATO position outlined in paragraph 42 of TR 2020/D3 referenced above. This concern is not limited to credit support rights and extends to any other rights that may be held by the borrower (or obligor).

9. Application of development carve out for credit support under a debt facility used for a staged development (i.e. stages in development and others in operation).

The draft guidance does not currently deal with the case of a portfolio financing or the financing of a staged development where financed assets comprise in part assets under development and in part assets in operation.

In these circumstances, the credit support provided for the portfolio financing in many cases relates solely to the assets under development and not to the operational assets. For example, the credit support may comprise an equity commitment deed covering the deferred equity to be committed to a project under development (noting that operational projects would have already drawn down their full equity commitments).

It is submitted that in the above case the credit support right relates solely to the development of the relevant CGT asset being financed for the purposes of the development carve out in sections 820-427A(5)(a)(iv)-(vi). In this regard, those sections are very specific in requiring that “a right relates wholly to the creation of development of a CGT asset”. The sections do not require that the only assets financed under the debt interest are CGT assets in development. Therefore, it is submitted that portfolio financings including both assets in development and operating assets may satisfy the requirements of sections 820-427A(5)(a)(iv)-(vi) where the other requirements are met.

Given that the above circumstances are extremely common in both project finance and M&A transactions it would be helpful if the ATO could include an example that confirms this interpretation to avoid any unnecessary confusion in the application of the credit support development carve out.

10. Application of compliance resources to an entity refinancing related debt with third party debt from a DDCR perspective.

The Taskforce submits that example 19 in PCG 2024/D3 may cause unnecessary concern and confusion unless further context and explanation is provided regarding the basis for the high risk assessment.

Paragraph 216 of PCG 2024/D3 states that:

> “This restructure presents risks that the refinancing of related party debt with third party debt merely has the effect of 'dumping' debt into Australia going forward, with an associated reduction in the third party debt issued by B Co's offshore group.”

The Taskforce respectfully submits its does not understand the ATO concern nor rationale behind this statement particularly as the proposed debt restructure does not increase the **net debt** of any member of the group. Does the ATO consider that the debt restructure should be assessed as lower risk if the related party debt had instead been funded out of cash reserves or equity contributed to BCo?

The Taskforce submits that the policy reason as to why the DDCR does not apply to entities applying the TPDT is that the application of the TPDT itself provides sufficient comfort that the third party financing represents a genuine commercial financing rather than a “debt dumping”. For that reason, the Taskforce cannot think of a circumstance where restructuring related party debt with genuine third party debt to which the TPDT applies could be considered a high risk restructure. On the contrary, the refinancing of related party debt with third party debt, particularly in the circumstances considered in example 19, would appear to be one of the intended policy outcomes of the interaction between the DDCR and TPDT.

11. Application of compliance resources to "permitted restructures" more broadly under PCG 2024/D3.

The ATO has indicated in PCG 2024/D3 that it will generally not apply compliance resources to certain restructures that occur by the end of the income year in which the draft PCG is finalised or, in the context of certain restructures, for income years ending on or before 1 January 2027 following the restructure.

In the third party financing context, changes to financial and related arrangements often require third party consent, e.g. lender's consent and, in the infrastructure sector, State consent. This may take some time to achieve, particularly where there are many third parties involved or where the State is involved.

The Taskforce respectfully submits that that the ATO should not apply resources to restructures that occur within 18 months after the draft PCG is finalised. This is a more realistic timeframe for taxpayers to make changes to their affairs in order to comply with the new thin capitalisation rules.