Corporate
Tax Association

Level 11, 455 Bourke Street
Melbourne, 3000

Tel: (03) 96004411
admin@corptax.com.au

16 February 2024

Mr Ben Kelly
Deputy Commissioner – Policy, Analysis and Legislation
Australian Taxation Office
PO Box 9977
Civic Square ACT 2608

By email: ben.kelly@ato.gov.au

Dear Ben,

Amendments to the Thin Capitalisation rules – ATO's Public Advice and Guidance consultation

We are writing to you in relation to the ATO's Public Advice and Guidance (PAG) consultation on the changes to the Thin Capitalisation rules including the debt deduction creation rules (DDCR). As we noted in our correspondence to you on 16 November 2023, the complexity of the changes proposed and the use of principles-based legislation requires the ATO to publish early, clear guidance on various areas of the proposed law.

The Corporate Tax Association (CTA) welcomes the ATO's public tabling of its PAG plan to the Senate Economics Legislation Committee (SELC), and that the ATO has commenced work on providing guidance. As you know, the CTA previously provided some initial thoughts on areas of priority and after further reaching out to our members, provides the following list of priority matters (assuming the Bill passes in its current form):

1. Business restructures that may be required as a result of the design of the new measures and the application of Part IVA from 1 July 2023 and the new anti-avoidance rules in section 820-423D from 1 July 2024. Such guidance should include examples.
2. The interaction of the interest limitation and transfer pricing rules, particularly on the quantum of debt.
3. Clarification on the extent of the minor and insignificant asset carve out from the Third Party Debt Test.
4. The general application of the DDCR in how it applies to:
    a) payment of dividends
    b) legal and equitable rights and obligations
    c) apportionment of interest
    d) new membership interests and capital contributions that are increases in capital
    e) the interaction with other provisions such as Division 7A
    f) restructures and section 820-423D including cash pools and tracing.

Further information on the above is provided in the attachment to this letter.

We would welcome the opportunity to discuss the contents of this letter with you further.

In terms of the consultation process supporting the development of this PAG, the complexity of the thin capitalisation legislation must equate to its supporting PAG being developed via an inclusive, transparent consultation process. To proceed on any other basis will only serve to further exacerbate confusion and frustration around its parameters.

We trust that the CTA's ongoing commitment to working alongside both Treasury and ATO on the development of extrinsic materials and ATO guidance documents for new law (as evidenced in the development of the process review for supporting new tax laws) will ensure that this process delivers PAG that assists taxpayers in navigating this complex legislation.

Should you have any questions or if you wish to arrange a meeting, please do not hesitate to Paul Suppree at psuppree@corptax.com.au or on 0408 185 050.

Yours sincerely,

Michelle de Niese
Executive Director

Copies to: Kirsten Fish (Second Commissioner, Law, ATO); Diane Brown (Deputy Secretary, Revenue Group, Treasury); Marty Robinson (First Assistant Secretary, Corporate and International Tax Division, Treasury)

Attachment A – Areas that require the ATO's consideration and guidance

1 Business restructuring and the application of anti-avoidance provisions

We welcomed the ATO commentary at the SELC hearing on 31 January 2024 that:

> *"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. Just to give you a little bit of an illustration on thin capitalisation, we did release a practical compliance guideline back in 2018 in relation to hybrid mismatched restructures and we've been looking to work with stakeholders to take a similar approach on this occasion."*

Whilst this is consistent with the Explanatory Memorandum in relation to the DDCR[1], we suspect the legislative design associated with the Third Party Debt Test (TPDT) and tax EBITDA calculations (particularly the fact the excess EBITDA capacity rules do not apply to economic interests between 10 and less than 50%) will also result in taxpayers having to restructure business operations and/or the location of debt or non-Australian assets to ensure debt deductions are not denied.

In this regard, the ATO needs to provide further guidance as to when and how they may or may not apply Part IVA of the *Income Tax Assessment Act 1936* as well.

2 The interaction of transfer pricing rules and the quantum of debt

As drafted, the transfer pricing rules apply before the interest limitation rules (albeit the debt deduction creation rules have primacy over both). The amount of debt deductions under arm's length conditions is generally the quantum of debt multiplied by the price (or interest rate) on that quantum of debt.

Current ATO guidance exists for the pricing of debt in PCG 2017/4 | Legal database (ato.gov.au). The PCG will require significant changes given references therein to asset values and EBITDA tests but little guidance on the quantum of debt.

3 The minor and insignificant asset carve out from the Third Party Debt Test

The Third Party Debt Test has changed to enable recourse to minor and insignificant ineligible (non-Australian) assets (sec 820-427A(30)(c)). This change is welcomed, but further clarity and the determination of the scope of the exclusion is needed.

We note the EM at paragraph 1.30 states that:

[1] At paragraph 1.44, *"The anti-avoidance rules in section 820-423D may also apply to any avoidance schemes relating to the debt deduction creation rules. However, these rules are not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules. The application of section 820-423D will ultimately depend on the facts and circumstances of each case."*

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

This statement adds little, if anything, by way of explanation or guidance.

4 The general application of the DDCR

a) Funding capital expenditure with debt whilst continuing to pay dividends

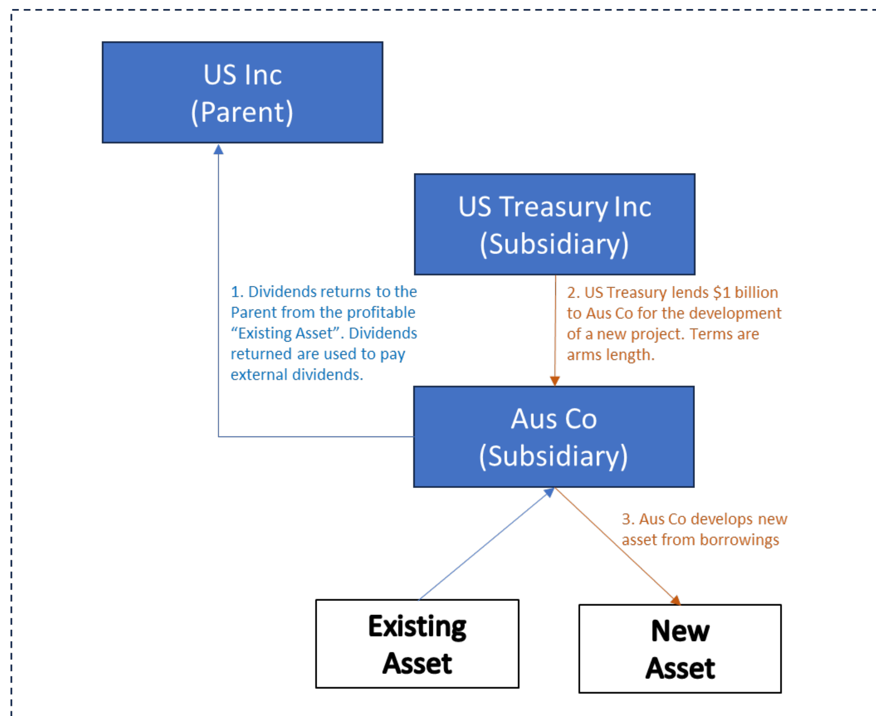
Whilst the revision to subparagraph 820-423A(5)(b)(ii) is more focused on linking the related party borrowing to the funding of a "bad" distribution or payment, it is possible to adversely impact "good distributions" such as the payment of a dividend.

In our view, as the word 'facilitate' in subparagraph 820-423A(5)(b)(ii) is undefined, it takes its ordinary meaning and is defined as *"to make an action or a process possible or easier"*. We note paragraph 1.49 of the latest EM tries to provide clarity on the term 'facilitate' (to be something equivalent to "indirect") but with respect, is more confusing. It states:

> *"…. [f]or the payer to facilitate the funding of a payment or distribution, there must be an indirect connection between the use of the financial arrangement and the funding of the payment or distribution. This may involve a consideration of whether the use of the financial arrangement can reasonably be said to have allowed for, directly or indirectly, the funding of the payment or distribution."*

As can be seen, the EM seems to "decouple" the use of the borrowing (which is the current legal test) to a test that the borrowing has reasonably allowed directly or indirectly, the funding of the payment or distribution. As such, the current drafting could see debt deductions being denied due to the mere existence of certain payments (such as a dividend) even where the related party debt was not used to fund that payment directly or indirectly, as it has potentially "allowed" the payment or distribution.

This is illustrated in the examples below:



In this example, Aus Co is a wholly owned subsidiary of a listed US multinational (US Inc) which is operating a gas-fired power station that it developed many years ago. It is quite profitable and has been regularly paying dividends to US Inc from cash generated from the existing project.

In 2025, it is looking to build a new renewable energy project that will take three years to construct but wishes to continue to pay dividends to US Inc from its existing asset's operating cash flows, as US Inc relies on these profits to pay its dividends to ultimate shareholders. Accordingly, Aus Co intends to borrow $1 billion from the US treasury subsidiary of US Inc (US Treasury Inc) to develop the new project. The interest rate and quantum of debt is set on arm's length terms.

On the current drafting, paragraph 820-423A(5)(b)(ii) may apply to disallow debt deductions as the new financial arrangement may have facilitated the funding of the dividend as it "made it easier" to pay the dividend.

Thus, the mere existence of a dividend and a financial arrangement that are unrelated or linked may result in the deductions being disallowed despite Aus Co borrowing from a related party to directly fund its capital expenditure and the dividend being paid out of cash flows.

Whilst the above example is the most common, there are variations of the above that would require further clarification. We note that these variations are ordinary business transactions and not artificially contrived schemes designed to create debt deductions. These variations include where:

1. A taxpayer accumulates some of their revenue in a separate bank account to fund dividend payments. As a consequence, it needs to borrow from a foreign related party to fund some of its opex and capex, as it does not have enough cash flows to fund both.

2. A taxpayer borrows to make an equity injection into a non-wholly owned subsidiary. That subsidiary uses some of the proceeds to pay a dividend.

3. A taxpayer intends to pay a dividend but needs to partly borrow to do so. It has headroom on a cross-border related party debt but instead borrows externally at a higher interest rate to pay the dividend. The external borrowing also has a s128F WHT exemption.

b) Application of subsection 820-423A(2) - legal and equitable rights and obligations

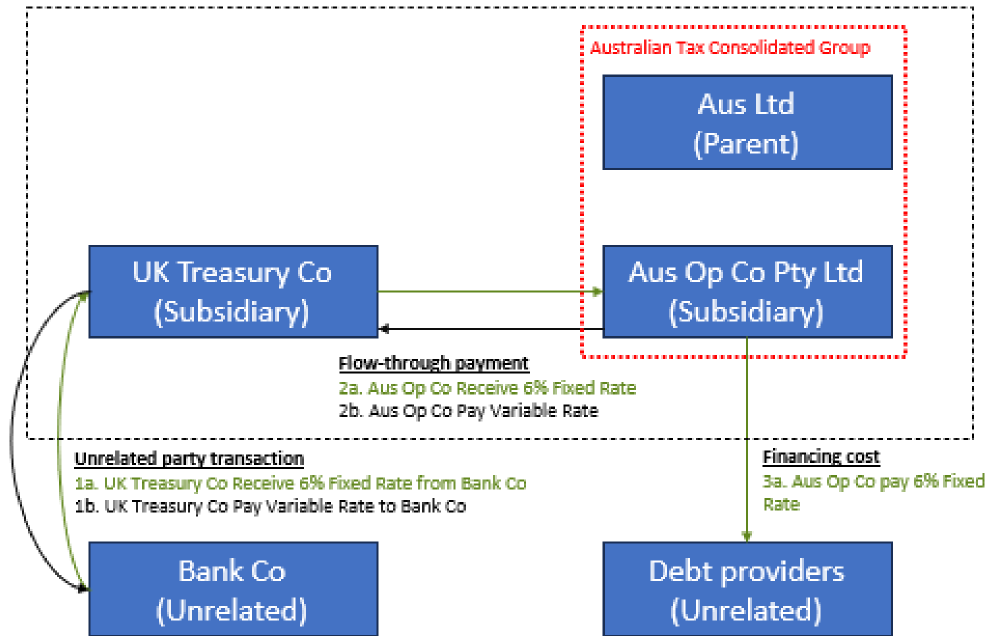
We note that subsection 820-423A(2) as drafted seems to interact with subsection (5). For example, the term 'legal or equitable obligation' could be interpreted to mean that the acquisition of services or insurance from a related party under a contract from a related party is within its scope.

Moreover, the overlap with subsection (5) can mean that the policy-based carve-outs applying to subsection 820-423A(5) are ultimately ineffective (as arrangements sought to be excluded under subsection 820-423A(5) are still inadvertently captured under subsection 820-423A(2)).

As an example, while the acquisition of a debt interest as a CGT asset is excluded from subsection 820-423A(2) for the *lender* by operation of subsection 820-423AA(3), the legal or equitable obligation acquired by the *borrower* when entering into the same debt interest is not explicitly excluded. Consequently, an entity borrowing from a related party can have interest deductions denied under 820-423A(2), even when the borrowed funds are used for a purpose that is neutral under the regime (e.g. payment of salary costs).

In addition, the acquisition of a 'legal or equitable obligation' can be interpreted to encompass derivative arrangements associated with hedging or managing financial risks, such as interest rate swaps or cross-currency interest rate swaps. When a taxpayer enters into a swap, it will acquire a right to receive future payments and come under a legal or equitable obligation to make payments under the arrangement. Where that swap is with a related party, payments under the swap (being 'debt deductions' under the extended definition) stand to be denied under 820-423A(2). This is the case even if the debt that is being hedged by the swap has been used for a neutral purpose or is even third-party debt.

The example below illustrates this.



In this example, the Australian-based global group has decided to centralise certain treasury functions in the UK to promote efficiency, process standardisation, etc. The UK treasury function, through UK Treasury Co (which maintains relationships with financial intermediaries) assists the global group in meeting several financial requirements including the acquisition of interest rate swaps and cross-currency interest rate swaps which are needed by the group's subsidiaries to hedge the financial risk associated with external borrowings.

Where Aus Op Co needs to enter into an interest rate swap to convert a $100m fixed rate loan to a variable rate, UK Treasury Co enters into a $100m fixed-for-floating interest rate swap on the market and provides a $100m fixed-for-floating interest rate swap to Aus Op Co on back-to-back terms (i.e. immediately and at cost).

The interest rate swap between Aus Op Co and UK Treasury Co is both a financial arrangement with an associate pair for subsection 820-423A(2) and also a legal or equitable obligation to an associate pair for subsection 820-423A(5). Because amounts received under the swap are paid away to debt providers, 820-423A(5) has no adverse application to the swap: 820-423A(5)(b) and 820-423A(5)(c). Nonetheless, 820--423A(2) appears to still apply, inappropriately, to deny all deductions under the swap.

Clarification from the ATO of the intended 'legal or equitable obligation' to be caught under subsection (2) would be beneficial including that obligations under related party services at arm's length are not intended to be caught under these rules.

c) Apportionment of interest

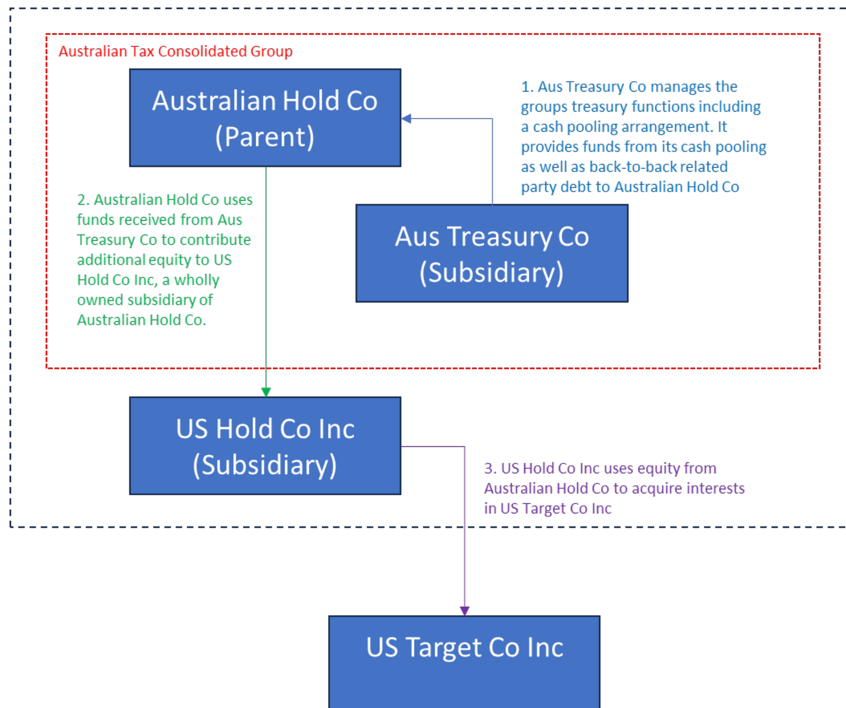
ATO Guidance will be needed on how to apportion interest denial for blacklisted related party transactions where tracing the use of funds is impractical. The principles in *Ronpibon Tin* are relevant here.

d) Newly acquired membership interest

As we have noted previously, some jurisdictions (including Australia and the US) allow equity to be subscribed without the need for new membership interests to be issued. Equity is contributed to an existing membership interest to increase the capital base.

In our view, the principles-based approach to drafting would allow for these increases in equity to be included, however the wording of the provision appears too narrow. As such, further consideration and guidance is required.

An example of situations where this would occur is illustrated below:



In this example, Australian Hold Co is the head of an Australian multinational group. Aus Treasury Co is a wholly owned subsidiary that manages the treasury function on behalf of the worldwide consolidated group.

Aus Treasury Co uses a combination of related party borrowings and funds sourced from its global cash management system and lends this to Australian Hold Co, which uses the cash to contribute capital to its existing wholly-owned US Hold Co parent entity.

US Hold Co Inc then uses the additional capital received to fund the acquisition by US Hold Co parent of US Target Co, which is wholly unrelated to the group. That subscription is in addition to existing contributed capital in US Hold Co as it does not involve the issue of new membership interests per se.

The current drafting would disallow the deduction for interest to Australian Hold Co as US Hold Co has not issued it with new membership interests. This fact pattern is, however, aligned to the policy intent and therefore the drafting as proposed above could be introduced to ensure the deduction remains available.

Another example would involve Australia Hold Co utilising related party borrowings to contribute additional equity into an Australian joint venture unit trust. Instead of issuing new units in the joint venture trust, Australia Hold Co contributes equity to the existing units that it holds in the trust. The current drafting would also disallow the deduction for interest in this situation.

e) Interaction with Division 7A

Currently, under Division 7A of the *Income Tax Assessment Act 1936* (a specific anti-avoidance rule), certain distributions from a trust to a private company can be deemed an unfranked dividend. To avoid triggering Division 7A, a trustee can enter into a "complying loan agreement" where the trust wishes to retain the use of the funds. Complying loan agreements must charge interest at a punitive benchmark interest rate and have minimum loan repayments.[2]

In such cases, as a trust and corporate beneficiary will be associates, the distribution could fall foul of the DDCR. The effect would be that as well as requiring punitive interest to be charged (and thus interest income received by the private company), the trust is also denied a deduction on the same amount. That is, the tax laws currently deem a punitive interest rate to be charged, and it appears the DDCR then denies the same deduction.

As such, further consideration and guidance on this is required.

In addition, further consideration of the following is also required:

i. The ATO issued TR 2005/12 dealing with the deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries.

ii. More recently, the ATO also issued PCG 2022/2 outlining the ATO's compliance approach to Section 100A. In the PCG, the ATO identified a number of "Green Zone" scenarios where a company or trust beneficiary allows their present entitlements to be made available to the distributing trusts ("trustee retention of funds") by way of loan on commercial terms.

f) Section 820-423D

The practical scope of the anti-avoidance rule in section 820-423D needs some practical guidance.

Examples of where further guidance is required include:

i. Where a taxpayer opts to acquire trading stock with external debt despite having access to cheaper related party debt.

ii. Taxpayers that use cash pooling (as it is the most efficient form of financing operations) may bifurcate cash from business activities from related party borrowings and trace the use of funds. Guidance about the act of bifurcating funds and tracing so that trading stock and other blacklisted acquisitions are not debt-funded will be necessary.

[2] See: Trust entitlements | Australian Taxation Office (ato.gov.au)

iii. Where a taxpayer replaces an existing internal financial arrangement with a comparable external financial arrangement. This may occur either because the internal financial arrangement is known to be blacklisted or because the historical information does not exist to determine and/or evidence a transaction with a suitable degree of certainty (noting obligation to lodge true and correct returns at that time a transaction was undertaken), whether or not the deductions under the arrangement are impacted by the DDCR consistent with paragraph 1.44 of the EM.

iv. How the provisions of the Bill work in relation to section 820-423D, namely whether section 820-423D is capable of applying in relation to restructures undertaken by taxpayers prior to the commencement of Subdivision 820-EAA where the effect of the restructure is reflected in assessment of later years.