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Mr Harjit Singh
Assistant Commissioner – Policy, Analysis and Legislation
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By email: harjit.singh@ato.gov.au

Dear Harjit,

ATO Public Advice and Guidance – Amendments to the Thin Cap rules

We are writing to you in response to the ATO discussion paper on public advice and guidance (**PAG**) titled *Amendments to the Thin Capitalisation rules.* We welcome the ATO's engagement on its development of PAG given that timely and transparent guidance is important for the effective administration of and compliance with the amendments.

The development of the PAG must equal the challenges faced by those taxpayers impacted by the law. Further, given the bulk of the new rules will apply from 1 July 2023, any guidance must be fast-tracked where possible.

To support the ATO's development of PAG, **Attachment A** to this letter provides detailed commentary and several examples (some of which have been already provided) that warrant the ATO's consideration, in particular, in relation to the restructuring PCG. These examples are not limited to high-risk areas but also include transactions that help taxpayers understand how the ATO will apply the law in the first instance.

In our view, the development of PAG should not be limited to high-risk examples. The ATO should also clearly articulate the types of fact patterns where the thin capitalisation rules, and particularly the debt deduction creation rules (**DDCR**), would not apply. Whilst these may be perceived as low risk, transparent permissive guidance is integral to providing certainty and lowering the overall compliance burden of taxpayers whilst also alleviating pressures on the ATO's private rulings program for those transactions that fall below a "high-risk line".

Should you have any questions or if you wish to arrange a meeting, please do not hesitate to contact me at sstaples@corptax.com.au or on 0403 152 157.

Yours sincerely,

Simon Staples
Assistant Director

A - Restructuring PCG

In some instances, business restructuring will be required as a consequence of the law and how the ATO will interpret it.

For the DDCR, the types of restructuring that may be required will depend on how the ATO will interpret subsections 820-423A(2) and (5). The need to restructure is consequential to the interpretation of these subsections and whilst some instances where a restructure may be required are clear cut, in other circumstances, it may not be. This is due to the design premise of the DDCR which denies debt deductions before the consideration of any carveouts. The result is that transactions and structures that are ordinary business dealings that are not artificial or contrived may be caught and may require restructuring to ensure debt deductions are not inappropriately denied.

The ATO must provide clear permissive guidance on how the ATO will interpret the law in conjunction with this PCG dealing with where compliance resources will be deployed.

This is important given that restructures do not happen overnight. We observe that at times, restructuring a group's financing arrangements can take considerable time (we have been told up to two years) due to the varying compliance and governance milestones that need to be met. Restructures often must be compliant with the Corporations Act and other governing rules and regulations here in Australia and overseas (not just tax laws), as well as being subject to internal governance requirements such as audit and risk committees and/or board approvals.

In the interim, a degree of certainty can be provided through the PCG. The ATO should use the PCG to outline transactions and structures to which the ATO would not apply its compliance resources. To support the ATO's development of this PCG, we are providing a range of examples below that require further consideration by the ATO.

In our view rather than answering the prompting questions, the most effective way to respond to the discussion paper is to provide examples including those that are low (or no) risk to which the ATO does not need to apply its compliance resources.

Low risk Third Party Debt Refinancing

Example 1 - Failing FRT and GRT and refinancing with third party debt

Private Co only has Australian assets and is wholly funded with a $100 million 5-year related party loan at an interest rate set under arms' length conditions. However, it is expected to be in breach of the Fixed Ratio Test (**FRT**) and Group Ratio Test (**GRT**). It borrows $100 million from an unrelated third-party bank on the same terms as the existing related party loan with the interest set at arm's length rates. It uses the funds to repay the $100 million related party loan and elects to apply the Arms' Length Debt Test (**ALDT**). The bank only has recourse to Australian assets.

This type of arrangement is low risk and the ATO should not apply compliance resources.

Other Low Risk Third Party Debt Test Restructures

Example 2 - Australian assets with a US Offshore Bank Account

Mining Co solely owns and operates a lithium mine in Australia and is funded with unrelated third-party debt from Foreign Bank Inc. Foreign Bank Inc only has recourse to the assets of Mining Co. Total Assets excluding cash are $US1 billion.

Mining Co sales are denominated in USD and all sales proceeds are paid into an offshore USD-denominated bank account with a different Foreign Bank, US Bank Inc. During the year, the balance in the US Bank Inc account is positive, after payment for operating costs, interest and loan repayments, taxes and dividends. The balance of the account varies during the year but is never more than $US50 million (or less than 5% of total assets) at any time during the year.

Mining Co has a FRT and GRT above 30% in 2024 and wishes to apply the Third Party Debt Test (**TPDT**).

The following questions arise and need to be addressed by the ATO:

1. Is the cash received and held by Mining Co in its US Bank Inc bank account an Australian asset, given it represents sales proceeds from the sale of Australian sourced lithium less costs, loan repayments, taxes and dividends) from operating the Australian-located lithium mine?

2. If the US Bank Inc bank account is not considered an Australian asset, is it considered minor or insignificant under section 820-427A(3)(c)?

3. If the bank account is not considered an Australian asset or minor or insignificant, will the Commissioner consider changing the banking arrangements such that cash sales are received in an Australian branch of Foreign Bank Inc low risk and not apply compliance resources to the arrangement?

4. If the bank account is not considered an Australian asset or minor or insignificant, will the Commissioner consider the arrangement of changing the banking arrangements such that cash sales are received in an Australian account of an Australian bank low risk and not apply compliance resources to the arrangement?

Example 3.1 – Rearranging Foreign Loans

Ozzie Outbound Ltd (Ozzie) is a subsidiary of Foreign Inc. Ozzie has $2 billion of Australian assets and owns $400 million of shares in a foreign subsidiary, Kiwi Ltd (Kiwi), thus has total assets of $2.4 billion. It also has a $1 billion loan facility with a syndicate of unrelated third-party banks. The banking syndicate has recourse to all of Ozzie's assets in the case of loan default. It is expected that

Ozzie will have an FRT in excess of 30% and a GRT in excess of 30%. Prior to the changes to the thin capitalisation rules, Ozzie relied on the arm's length debt test.

The loan is due for repayment in 2027, but being aware that it would not meet the TPDT under the new rules due to lenders having recourse to foreign assets, Ozzie and the banking syndicate amend the loan arrangement so that the banks do not have recourse to Kiwi shares.

Example 3.2 - Rearranging Foreign Assets

Following on from the facts in example 3.1, rather than amending the loan agreement, Ozzie transfers all its Kiwi shares to sister entity Kiwi Holding Limited owned by Foreign Inc and the existing loan arrangements are changed such that Ozzie and Kiwi Holding Limited are separately funded by the banking syndicate on arm's length terms with the $1 billion debt bifurcated (based on an arms' length split) such that $833 million of the loan is with Ozzie and $167 million is with Kiwi Holdings Limited. The banking syndicate only has recourse to the assets of Ozzie for the Australian loan and New Zealand Holding assets for the New Zealand loan.

Ozzie still relies on the TPDT after the restructuring as it still has disallowed interest if it applies the FRT or GRT.

Example 3.3 – Foreign Business that is a CFC – Low Risk

Widget Co operates a manufacturing plant in Australia and has total Australian assets of $1 billion. It also has a captive insurance subsidiary, a controlled foreign company (**CFC**), which is a resident of Singapore with a value of $50 million. Widget Co attributes all the income of the CFC under Australia's CFC rules (and is deemed an Australian resident under Part X). The subsidiary has a foreign bank account holding $50 million, being the premium received, less cost incurred. Widget Co is financed by a banking syndicate with an unsecured loan of $700 million, and the banking syndicate has recourse to all of Widget Co's assets including the captive insurer.

Due to having significant recurring expenditure on the maintenance of its fixed assets, which is capitalised for accounting purposes, but which is deductible for tax purposes, it fails the 30% FRT and GRT and wishes to rely on the third part debt test.

1. Will the shares in CFC be treated as an Australian asset?
2. Will the bank account in CFC be treated as an Australian asset?
3. If the shares in CFC or the bank account in CFC are not Australian assets, will they be treated as minor or insignificant?
4. Will the ATO not apply compliance resources, given the income from CFC is fully attributed and economically treated as if it was an Australian asset?

DDCR Transactions and Restructures

Example 4 – Funding capital expenditure with debt whilst continuing to pay dividends

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, Aus Co 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. 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 are set on arm's length terms.

During consultation on this measure, Treasury confirmed that the DDCR does not apply here as the EM seeks 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, we seek confirmation that the ATO's approach to this example will be in line with Treasury expectations and that it should not be subject to the DDCR nor should the ATO apply compliance resources to transactions of this nature.

This approach should also extend to variances to the above that are not artificially contrived schemes designed to create debt deductions such as 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 flow to fund both.

2. A taxpayer borrows to make an equity injection into a non-wholly owned subsidiary to fund its business. That subsidiary uses some of the proceeds received 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 loan but instead borrows externally at a higher interest rate to pay the dividend. The external borrowing also has a s128F WHT exemption.

Example 5 - Replacing related party debt with external debt

Assuming the same facts as Example 4, as the DDCR is uncertain in application, Aus Co is looking to borrow from Bank Co (unrelated) to repay its loan to US Treasury Inc.

The breadth of section 820-423D could be interpreted to deny deductions associated with the external debt; specifically, the low threshold of the words "reasonable" and "principal purpose" may be applied to classify this transaction as being used to avoid the application of the DDCR at the time of the refinancing.

Such an interpretation would be inconsistent with:

- Paragraph 1.39 in the EM where Amendment 54 seeks to ensure that the DDCR is appropriately targeted, and
- Paragraph 2.146 of the EM accompanying the original bill explains that the new Subdivision seeks to disallow debt deductions to the extent they are incurred in relation to debt creation schemes that lack genuine commercial justification.

Therefore, section 820-423D should not be applied apply to restructuring where related party debt has been refinanced with external debt on a commercially driven project. We request the ATO confirm this is how the rules will be interpreted and administered to ensure the rules remain appropriately targeted.

The ATO should not take any approach contrary to the guidance in the EM, so any instances of this and reasons for doing so must be made clear.

Example 6 - Application of subsection 820-423A(2) – assets, legal and equitable obligations

The overlap of subsection 820-423A(2) with subsection 820-423A(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)).

For 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/issuing the same debt interest is not explicitly excluded. Consequently, on one interpretation of the law, 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, deposit with external financial institution, etc). A similar outcome could potentially apply where related parties merely enter into a financial derivative arrangement, such as an interest rate swap.

AUS Parent is an Australian listed company and is the head company of a tax consolidated group of which AUS Finance Co is a member. AUS Finance Co acts as the treasury entity for the global group. Foreign Co is a non-Australian subsidiary of AUS Parent. Foreign Co is profitable and USD funds from its earnings are placed on deposit with AUS Finance Co and attract an arm's length interest rate.

AUS Finance Co uses the USD received from Foreign Co initially to deposit in its USD bank account with a bank and subsequently on operational spending with unrelated parties.

Whilst subsection 820-423A(5) should not apply to the borrowing by AUS Finance Co from Foreign Co, because the borrowed funds are used for wholly for operational spending or investment with unassociated entities[1], subsection 820-423A(2) may apply, as the key elements seem to be satisfied, including:

[1] And, specifically, not any payment covered by 820-423A(5A)

- Acquisition of CGT asset (foreign currency) [2] by an Australian entity (AUS Finance Co) from an associate pair (Foreign Co),
- Australian debt deductions relate to the acquisition of that CGT asset from an associate pair,
- Australian debt deductions relate to interest that is payable to an associate pair (Foreign Co), and
- no exception in section 820-423AA applies to AUS Finance Co (noting that subsection 820-423AA(3) is not satisfied because AUS Finance Co does not *acquire* a debt interest, but is the *issuer* of a debt interest).

Clarification on how the inappropriate overlap of subsection (2) and (5) will be avoided, as well as the scope of 'legal or equitable obligation[s]' intended to be caught under subsection (2), is crucial to achieving certainty in the practical application of the rules. This includes whether the ATO will apply compliance resources to these ordinary business transactions.

Example 7 - Use of unrelated party debt to finance the purchase of trading stock

Distributor Co purchases widgets from its Singapore-based parent on a 1 month deferred payment basis and pays interest on repayment of the trade loan at arm's length rates.

Being aware of the DDCR, Distributor Co decides to borrow from an unrelated third-party bank and purchase all future widgets on a cash basis from its Singapore parent. The third-party bank charges interest at arm's length rates.

This arrangement is low risk and the ATO should not apply compliance resources to the arrangement. This includes considering whether section 820-423A(2), subsection 820-423A(5) or section 820-423D applies.

Example 8 – Related party bridging finance

Infrastructure Co SPV is an Australian incorporated entity and carries on projects in Australia. It is commencing a new infrastructure project in Australia for which capex spend will be $300m. However, due to commercial issues causing delays in obtaining external funding, bridging finance by way of shareholder funding is required for $50m.

Once bank financing is put in place for the total cost of the project of $300m, a portion of the funds will be used to repay all shareholder funding of $50m.

This arrangement is low risk and section 820-s423D should not be applied, nor should the ATO apply compliance resources to the arrangement. We seek confirmation from the ATO of this position, as well as whether any views are different depending on the nature of the bridging finance being repaid (i.e. if there is a return of contributed capital, a repayment of an interest free shareholder loan, or an interest bearing shareholder loan etc.).

[2] Alternatively, or in addition, there may be an acquisition of a legal obligation by AUS Finance Co from Foreign Co, namely the obligation to repay the foreign currency. In this case the subsequent requirements can also be modified *mutatis mutandis* to relate to the obligation.

Example 9 – choosing to use unrelated party debt where related party debt was available

Aus Co is looking to acquire a line of trading stock from a related party Warehouse Co. However, to acquire new trading stock Aus Co needs to obtain working capital. At the time, Aus Co could have secured funds from US Parent Co at an arm's length rate, however, it decides to finance the acquisition of trading stock using a third-party debt facility at a slightly higher interest rate.

Section 820-423D should not apply in these circumstances merely because there was an option to use related party finance, but the decision was made to secure finance from an unrelated bank due to the application of the DDCR.

In other words, optionality should not warrant the application of section 820-423D or Part IVA in these circumstances.

Similar examples of the potential misapplication of section 820-423D include:

1. Taxpayers that use cash pooling (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 is necessary.

2. 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 the tax record keeping requirements that were relevant at that time a transaction was undertaken and the obligation to lodge true and correct returns for the 2025 income tax year), whether or not the deductions under the arrangement are impacted by the DDCR consistent with paragraph 1.44 of the EM.

3. Restructures undertaken by taxpayers prior to the commencement of Subdivision 820-EAA where the effect of the restructuring is reflected in the assessment of later years.

DDCR tracing and apportionment

We observe that due to the lack of grandfathering in the application of the DDCR, it may be possible for some taxpayers to conduct tracing on a basis such as using the FIFO methodology while for others, the historical nature of lending and associated records may be so voluminous that it would be burdensome, costly and inefficient to conduct a tracing exercise.

Understanding how the ATO will approach tracing will be critical in determining how apportionment would need to occur thereafter.

We provide some examples below that provide a practical solution for historical transactions that are highly voluminous and an alternative for those taxpayers who can reliably conduct a FIFO analysis.

<u>*Example 10.1 – Practical solution to voluminous tracing associated with historical general purpose loans – low risk*</u>

Aus Co currently has outstanding loans with its foreign parent. The debt funding was provided on a general basis (annually) to support Aus Co's needs for the relevant historical years which included the construction of infrastructure.

Aus Co has refinanced outstanding loan balances over time with the original loan being more than 20 years old. In the year where the original debt was provided, the business was also generating cash from operations which was also used to fund operations (i.e. mix of debt/ operating cashflow funding). Whilst funds were largely used to pay the general operations and project construction costs, payments of the business would have also included dividends, royalties and related party trading stock purchases.

Part of the loans have been paid down over time with the balance still outstanding (interest being paid on balance).

Given the general nature of the loans, tracing expenditure in the relevant periods would be extremely difficult and require a whole-of-business assessment over 20 years. As such, we recommend a reasonable and practical approach should apply with respect to the application of the DDCR provisions to such historic loans.

The proposed methodology includes:

1. For determination of what was historically debt funded:

   Debt vs Operating cashflow – 'Captured payments' can first be considered paid on a first in, first out basis from operating cash to the extent available and then from loan balances. That is, to the extent historic 'captured payments' can be reasonably estimated to be less than the business operating profits at the time of the loan injection, no adjustment is required. (Statutory accounts or other reliable accounting records could be used to determine business profits).

2. If captured payments are greater than operating profit, then deny interest on that proportion of debt deductions in loan balances.

3. Furthermore, where the 'captured payments' amount can reasonably be estimated to be a small portion of the outstanding historic loans (say 5% of the loan balance amount), no adjustment is required.

The above is a risk-based approach based on materiality that can be applied by taxpayers on historic loan balances and limit tracing and apportionment requirements.

Illustration of application:

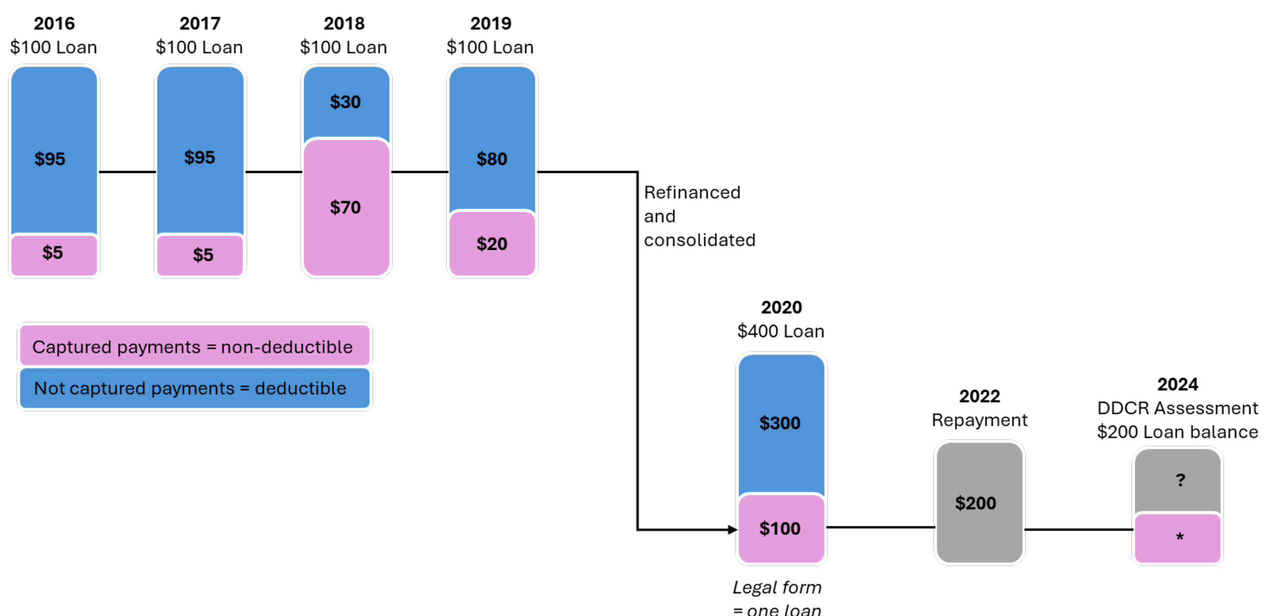
- Company A had a general loan injection of $100 (from the overseas parent) in 2004. Over the same year, Company A had $100 in business operating profits. It was reasonably estimated that in that year $115 of 'captured payments' (e.g., dividend/acquisition of

trading stock from associates) were made. $10 of the loan has been repaid over the following 20 years with $90 of the loan still remaining outstanding in 2024.

- Applying the above:
  - $115 (captured payments) less $100 (business profits) = $15 'captured payments' to deal with from 2004.
  - Less $10 loan repayments. This leaves $5 captured payments in the current loan balance.
  - $5 "captured payment" over $90 loan balance equals 5.5%.
  - Interest on the loan balance of $90 in 2024 is $10.
  - 5.5% of $10 debt deductions is denied.

<u>*Example 10.2 – Practical solution historical loans that have been refinanced and consolidated*</u>

Like 10.1 above but this time, Aus Co has refinanced all loans and consolidated them into one debt facility. It uses excess funds to pay down the loan. This is set out in the diagram below:



Applying the logic from example 10.1 to this fact pattern:

1. If there is operating cash available in the relevant years, then 'captured payments' first applied against that (i.e., captured part not considered part of loan balance to the extent it is paid from operating cash).
2. If the loan has 'captured payments' after applying (1), then historic repayments can be first considered against the 'captured payments' part.
3. If the loan still has some 'captured payments' element, then could apply a materiality threshold (last resort).

It is reasonable that a taxpayer would seek to pay down loan balances (or part thereof) that relate to 'captured payments'.

Example 11 - Using FIFO to trace borrowings under a cash pool for dividends

Aus Sub Co is an Australian resident subsidiary of Head Co. Head Co is a foreign resident. Aus Sub Co has a cash pool facility with Fin Co (a foreign resident subsidiary of Head Co) where its net cash inflows and cash outflows are swept to on a daily basis (**Cash Pool Facility**). Cash inflows comprise receipts from sales to customers, and cash outflows comprise operating and capital expenditures. Aus Sub Co is a net borrower from Fin Co under the Cash Pool Facility due to funding of significant capital expenditure projects in Australia in the past. The interest rates applying to the Cash Pool Facility are benchmarked against arms' length rates. Interest accrues on a daily basis and is calculated by reference to the daily balance of the facility.

On 1 January 2023, Aus Sub Co paid a dividend of $500 to Head Co which was funded with a borrowing from Fin Co for the same amount through the Cash Pool Facility. As at 1 July 2024 (the start date for Subdivision 820-EAA), the balance of the Cash Pool Facility is in a net payable position with Aus Sub Co owing $1,000 to Fin Co.

Aus Sub Co's accounting records evidence the balance of the Cash Pool Facility before and after the 1 January 2023 dividend borrowing as follows:

Transaction No	Description	Date of transaction	Debits (net borrowings by Aus Sub Co)	Credits (net deposits by Aus Sub Co)	Running daily balance
	Opening balance as at 1 January 2023		-	-	-$500
1	Net daily cash pool transaction (**comprising $500 dividend borrowing only**)	1 January 2023	-$500	-	-$1,000
2	Net daily cash pool transaction (net amount deposited / borrowed from sales revenue and operating and capital expenses)	2 January 2023	-	$500	-$500
3	Net daily cash pool transaction (net amount deposited / borrowed from sales revenue and operating and capital expenses)	3 January 2023	-$100	-	-$600
4	Net daily cash pool transaction (net amount deposited / borrowed from sales revenue and operating and capital expenses)	4 January 2023	-	$500	-$100

<table>
<tr><td></td><td colspan="5">Aus Sub Co's accounting records evidence daily net deposit / borrowings with Fin Co on a daily basis including through to 1 July 2024. Aside from the 1 January 2023 dividend borrowing, all other amounts borrowed by Aus Sub Co related to the funding of operating and capital expenditures and did not relate to the acquisition of any assets from associates or the payment of any dividends, capital returns, royalties or similar payments to an associate.</td></tr>
<tr><td></td><td>Closing balance as at 1 July 2024</td><td></td><td></td><td></td><td>-$1,000</td></tr>
</table>

Application of the DDCR

The DDCR does not disallow any deductions for the interest Aus Sub Co incurred under the Cash Pool Facility on or after 1 July 2024.

Whilst there was a historical borrowing under the Cash Pool Facility that funded the payment of a dividend to an associate, interest incurred after 1 July 2024 is not disallowed under the DDCR because not all of the requirements of s820-423A(5) are satisfied.

Paragraph 820-423A(5)(b) is not satisfied because Aus Sub Co's use of the Cash Pool Facility as at 1 July 2024 does not to any extent relate to the funding of the 1 January 2023 dividend.

Further, paragraph 820-423A(5)(e) is not satisfied because Aus Sub Co's debt deductions are not 'referable' to an amount paid or payable to its associate pair (Head Co). Any interest incurred after 1 July 2024 is calculated by reference to the daily outstanding balance of the Cash Pool Facility. No part of the outstanding balance of the Cash Pool Facility as at 1 July 2024 is referable to the amount borrowed to pay the 1 January 2023 dividend.

Using a first in, first out (FIFO) methodology to trace the borrowing of the dividend and amounts repaid/deposited by Aus Sub Co under the facility, the amount borrowed on 1 January 2023 was repaid no later than 4 January 2023.

That is, applying a FIFO methodology, Aus Sub Co can show that the balance of the Cash Pool Facility as at 1 July 2024 does not relate to the amount borrowed for the 1 January 2023 dividend.

<u>Example 12 - Tracing borrowing under cash pool for dividend and refinancing</u>

Same facts as Example 11, except:

- On 4 January 2023, Aus Sub Co entered a refinancing transaction where Fin Co 2 (also a foreign resident subsidiary of Head Co) lent it $100 (**Replacement Loan**).
- Aus Sub Co uses the proceeds of the Replacement Loan to repay the Cash Pool Facility.
- Aus Sub Co enters into a new cash pooling arrangement with Fin Co.
- As at 1 July 2024, the Replacement Loan remains owing by Aus Sub Co to Fin Co 2.

Application of the DDCR

The DDCR does not disallow any deductions for the interest incurred under the Replacement Loan after 1 July 2024.

For the purposes of applying subparagraph s820-423A(5A)(f) to the Replacement Loan, the repayment of the Cash Pool Facility is not referable to a debt interest that was a financial arrangement that satisfied paragraphs 820-423A(5)(a), (b) and (c). At the time the Cash Pool Facility was refinanced/repaid, the balance of the Cash Pool Facility did not relate to the borrowing by Aus Sub Co for the 1 January 2023 dividend paid to Head Co.

Therefore, for the purposes of applying subparagraph s820-423A(f)(ii) to the Replacement Loan, subparagraph 820-423A(5)(b) would not be satisfied at the time of the repayment of the Cash Pool Facility.

The outcomes in Examples 11 and 12 are consistent. That is, there is no difference between a debt that funded a dividend (or other captured payment) and a refinancing of a similar debt.

B - Third Party Debt Test

Minor or insignificant asset carve out from the Third-Party Debt Test

The TPDT has changed to enable recourse to minor or insignificant ineligible (non-Australian) assets (section 820-427A(3)(c)). Further clarity and the determination of the scope of the exclusion is needed.

We note the EM in paragraph 1.30 states that:

> *"[D]etermining 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 by way of explanation or guidance. Taxpayers will therefore require clear guidance from the ATO as to how the ATO will interpret this phrase. Given that the "minor or insignificant" exemption could apply to a wide range of affected taxpayers, it is suggested that it is interpreted as a percentage of gross assets of the relevant obligor group rather than a fixed number. This could be based on asset values between 5% to 10% of total asset values given that some case law exists that indicate less than 10% is minor and insignificant[3], whilst section 9 of the *Corporation Act 2001* defines a "substantial shareholder" as an entity that holds 5% or more of the total votes.

List of credit support instruments

Credit support instruments can vary. Given the restriction to use the TPDT where there is parental support (such as a guarantee), the ATO should provide its views on a list of credit support instruments it views as being parental support.

In doing so, the ATO should also confirm that guarantees provided by members of the same tax consolidated group (**TCG**) as the borrowers are to be ignored under the single entity rule because the TCG is already liable under the loan terms and that the guarantee does not provide any additional recourse to the banks/lenders.

If the ATO would like further information on the type of instruments to which further consideration is needed, we can provide these at a later stage.

Parent company guarantee and other credit support rights permitted during the development of certain projects

Subsection 820-427A(5) allows credit support to be provided during the creation or development of certain CGT assets of the types listed in subparagraphs (a)(iii) to (vi) - which include renewable energy projects. It would be beneficial for the ATO to provide a confirmation that credit support can continue to be provided until the project is deemed to be fully operational pursuant to the project finance criteria.

[3] See Case 21/96 heard by the AAT at paragraph 53; Case 2/96 head by the AAT.

In a portfolio project finance scenario, project finance is obtained for a number of projects under development. It would also be beneficial for the ATO to confirm that credit support can continue to be provided until each project is deemed to be fully operational. For example, if the portfolio financing covers Project A and Project B, credit support pertaining to Project A will fall away when Project A is fully operational, credit support pertaining to Project B can continue until Project B is fully operational.

Conduit Financing

Whilst a conduit financier is permitted to pass on swap-related benefits and costs under the terms of the on-lending agreement, it is unclear whether back-to-back swap arrangements are permitted. The most common swap arrangement would be for the conduit financier to enter into a swap (for example cross currency interest rate swap), and then to enter into back-to-back swap arrangement with the entities to which it is on-lending.

Third party debt used to acquire shares or units in a company or trust

It is unclear as to whether interest would be deductible under the third-party debt test where third party debt is used to purchase shares or units in a company or trust which, while incorporated in and carrying on business in Australia, also has foreign investments (either direct projects such as a foreign branch or through indirect projects such as shares in foreign subsidiaries).

This relates to whether the acquisition target is "Australian assets" for the 'use of funds' requirement. If the foreign components are not minor or insignificant, does the relative size of the foreign investment affect the answer (e.g. under 50% or over 50% of target value)?

In our view, this PAG product should provide certainty as to how the ATO sees the law applying in this instance.

Quantum of debt, parental guarantees and notional Australian business

In many instances, taxpayers will not be entitled to use the TPDT due to the having a parental guarantee in place. This suggests (though it may be unclear) that a taxpayer would need to test the quantum of external debt and to see whether it is arm's length. Clarification on this point that no further testing is required should be addressed by the ATO as part of this PAG product.

Further, as the requirement for dealing with the notional Australian business requirement has been removed, we understand that taxpayers should be able to satisfy the quantum requirement by utilising the broader group's debt capacity. It would be useful for the ATO to confirm this understanding.

C - Amendments to existing Transfer Pricing PAG

Understanding what the ATO views as acceptable capital structures and the Quantum of Debt

It is important that the ATO clearly sets out what it considers to be a low-risk capital structure that includes related party finance. In many instances, related-party financing is the most efficient and cost-effective form of financing operations and investment. We think that it is unreasonable for the ATO to contend that taxpayers should not incur debt, nor should it come into existence as was put forward by the Commissioner in *Mylan*[4]. We submit that in the majority of instances, this is unrealistic, and the amount of equity needed to fund most capital-intensive projects and infrastructure cannot be achieved through equity alone. Debt is a necessary and normal part of funding operations and expansions. Using solely equity would also increase the cost of capital to such an extent it would be difficult to meet project hurdles for investment to occur.

Ultimately, understanding what capital structures are considered low risk should then assist with understanding the quantum of debt allowed within in capital structure. This is vital as the transfer pricing rules apply before the interest limitation rules (albeit the DDCR have primacy over both), with the amount of debt deductions under arm's length conditions simply the quantum of debt, that is, how much debt a taxpayer is allowed to have, multiplied by the price (or interest rate) on that quantum of debt.

With the onus of proof on taxpayers and a high evidentiary bar to then demonstrate quantum, clear factors need to be provided to ensure taxpayers can clearly understand how their structures and quantum will be considered by the ATO. Similar to the guidance that existed for the ALDT, the ATO should be clear in outlining whether these factors are both quantitative and qualitative. Providing this clear guidance as to how the ATO will approach the required level of evidence will enable taxpayers to then appropriately manage their transfer pricing affairs, including managing an ever-increasing cost of compliance.

If the concern is about pricing of the structure, then the transfer pricing rules would then deal with disputes in pricing before any interest limitation rules apply.

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

Of particular importance in any analysis are recent cases (such as the recent decision in *Singtel Australia*[5]) subsequent to the development of this PCG which impute parental support at no cost to the subsidiary. It is strongly arguable that if there is parental support, then questions arise as to whether in fact there is any restriction on the quantum of debt that a third-party lender would lend to a subsidiary if a parental guarantee (or another form of credit support) is in place, and thus the only restriction is disallowance under the thin capitalisation rules.

[4] See Mylan Australia Holding Pty Ltd v Commissioner of Taxation (No 2) [2024] FCA 253
[5] See Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation [2024] FCAFC 29

Low Risk / Green Zone for debt deductions under the TPDT

As explained in paragraph 2.90 of the Explanatory Memorandum to the Bill:

> "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."

Given this, it is suggested that, where a taxpayer is subject to the thin capitalisation provisions and is claiming a deduction for interest under the TPDT method, it is made clear that they will be low risk and consequently in the Green Zone in an updated ATO Risk Assessment framework.