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Mr Stephen Dodshon
Acting Assistant Commissioner – New Measures
Australian Taxation Office
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SYDNEY NSW 2001

By email: stephen.dodshon@ato.gov.au

Dear Stephen,

Taxation Ruling TR 2024/D3 and Schedules 3 and 4 of Draft PCG 2024/D3

We are writing to you regarding Draft Taxation Ruling TR 2024/D3 dealing with certain aspects of the Third Party Debt Test (**TPDT**) and Draft Schedules 3 and 4 to Practical Compliance Guideline PCG 2024/D3 outlining the ATO compliance approach to thin capitalisation and TPDT restructures.

We welcome the opportunity to provide comments in relation to the ruling and PCG and, to support the ATO's development of the final ruling and PCG, we provide some commentary and recommendations in the **attachment** to this letter.

As we have noted in previous correspondence, the timely development of public advice and guidance is important for the effective administration of and compliance with the amendments. This is because the changes to Australia's thin capitalisation regime will require many taxpayers to restructure ordinary business financing transactions. The restructuring of these transactions is not straightforward and can take considerable time to implement. It has been put to the CTA that this can take up to two years due to the varying compliance and governance milestones that need to be met.

We would welcome the opportunity to discuss the contents of this letter with you further. If you wish to arrange a meeting, please contact me at sstaples@corptax.com.au.

Yours sincerely,

Simon Staples
Assistant Director

Summary

As noted in previous submissions to Treasury in the development of the Bill and previous correspondence and submissions to the ATO, the changes to Australia's thin capitalisation regime will require many taxpayers to restructure ordinary business financing transactions. The restructuring of these transactions is not straightforward and can take considerable time to implement. It has been put to the CTA that this can take up to two years due to the varying compliance and governance milestones that need to be met.

Restructures often have to comply with the Corporations Act and other governing rules and regulations (not just tax laws) and obtain Audit and Risk Committee and board approvals. Those industries for which the Third Party Debt Test (**TPDT**) was designed will also need to restructure previously compliant financing transactions (see examples in schedules 3 and 4 of Draft PCG 2024/D3 (**draft PCG**)). This takes time and, as the views put forward in the Draft Taxation Ruling TR 2024/D3 (**draft ruling**) and the draft PCG are preliminary and may be subject to change, there is still considerable uncertainty for taxpayers despite the rules applying from 1 July 2023.

We also observe that the design of the TPDT is said to be narrow and to accommodate only genuine commercial arrangements relating only to Australian business operations.[1] We understand that this narrow design forms the basis of the draft ruling's design. However, the guidance must balance narrow interpretation and commercial realities to ensure that the TPDT is not unviable or unworkable for the taxpayers it was designed for such as asset-heavy sectors with long depreciation periods.

In designing the draft ruling and draft PCG, guidance should be taken from paragraph 2.12 of the Explanatory Memorandum which states:[2]

> *"The earnings-based tests are supplemented by a third party debt test, which allows debt deductions to be deducted where those expenses are attributable to genuine third party debt which is used to fund Australian business operations."*

To support the development of this important public advice and guidance, we provide some commentary below.

Part A: Commentary on Draft Taxation Ruling TR 2024/D3

Recourse

We note that paragraph 40 of the draft ruling correctly notes that the concept of recourse is different from the concept of security. We think that this paragraph would benefit from defining what each is before the context provided in paragraphs 41 to 43. That is, recourse refers to the lender's legal right to pursue the borrower personally for repayment, whereas security refers to the assets pledged as collateral for the loan while security provides the lender with a tangible asset that can be seized and sold if the borrower defaults, offering a form of protection even if the borrower's other assets are insufficient or unavailable.

[1] Explanatory Memorandum to Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024.
[2] Ibid.

Minor or Insignificant

The phrase “minor or insignificant” was not defined in the amendments to Division 820. Consequently, the words should take their ordinary meaning. We also acknowledge that no definitive quantitative guidance was provided in the legislative materials other than paragraph 1.30 of the Explanatory Memorandum which states:[3]

> *“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.”*

Paragraph 64 of the draft ruling suggests that the exception covers assets of minimal or nominal value, however, we submit that paragraph 820-427A(3)(c) only requires disregarding recourse to minor or insignificant assets. The wording of the provision should not be confused. While ‘nominal’, like ‘minor’ and ‘insignificant’, refers to things that are small or less important, nominal usually implies a recognised but small value, minor indicates something that is small in importance but still noticeable, and insignificant implies something so small that it essentially does not matter or have an effect.

Although used in a different context, in the recent case of *Benbrika v A-G (Cth)* in the Supreme Court of Victoria [2024 VSC 265 at paragraph 240] the judge noted that:

> *“However, the expressions “minor, insignificant or inconsequential” are imprecise. The expressions are also inherently evaluative, and necessarily require the drawing of conclusions that may be highly contestable. Because non-compliance with an ESO condition attracts criminal liability, an ESO must be certain, and understood by those who are subject to it, as well as those who enforce it.”*

The use of ‘minor or insignificant’ in paragraph 820-427A(3)(c) would indicate that you simply cannot look at nominal value. It suggests that using materiality as a metric for determining whether something is minor or insignificant is equally relevant.

Paragraph 1.30 of the Explanatory Memorandum states:[4]

> *“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.”*

Read with paragraph 820-427A(3)(c), this suggests that you need to look at it in the context of the Australian assets that are available to the lender as recourse. It is why in our view, the outcome in Example 9 of the draft ruling is incorrect Assets that represent 2% of all the assets of Aus Hold Co group, whilst not nominal or insignificant, are in fact minor.

Therefore, paragraph 72 should be amended to say that “the shares in NZ Sub Co are minor or insignificant…”. Similarly, paragraph 76 of Example 10 and paragraph 93 of Example 13 should also be amended to correctly reflect the wording in paragraph 820-427A(3)(c).

This approach would ensure that the concept of minor or insignificant is determined on a case-by-case basis based on the facts and circumstances of each taxpayer.

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[3] Ibid.
[4] Ibid.

Commercial activities in connection with Australia

In our view, the draft ruling adopts an over-restrictive approach to the term "commercial activities in connection with Australia". Whilst it is recognised the TPDT is designed as "narrow" and applies to certain capital-intensive industries, this should not translate to the commercial activities of such industries where debt is used for capital management purposes as not being "commercial activities". The very essence of commercial activity in a company is the generation of profit and the payment of a dividend to shareholders and to conclude this is not "commercial" or in connection with Australia is, with respect, unrealistic.

Whilst we acknowledge that in Example 15 the proceeds of issuing the debt interest are not all or substantially used to fund commercial activities in connection with Australia, the same cannot be said for Example 16. As mentioned on our recent call, the interpretation given to the collective phrase in section 820-427A(3)(d) – and dissecting the phrase into component integers and trying to articulate an individual meaning to the phrase "commercial activities in connection with Australia" without the full context of the section - misses the context of the following sub-paragraphs (i) and (ii).

In our view, read as a whole, subsection (d) – including all subparagraphs - is no more than emphasizing the use of the funds must not have a connection to the business or shares in a foreign entity. There is nothing that indicates it applies to commercial activities in the nature of payment of a distribution to a foreign shareholder from a business wholly operating in Australia that makes it a commercial activity in connection with Australia.

If the ATO is of the view that this section is aimed at denying interest on third party debt used to fund distributions or similar capital management activities, it should also address the position under sec 8(1) of the ITAA and the position outlined in TR 95/25, particularly at paragraphs 13 to 15 which states:

> 13. Applying the reasoning of the Full Federal Court in *Roberts and Smith* to companies will mean that interest on a borrowing by a company <u>may be deductible where the borrowing is used to fund a repayment of share capital to the shareholders in circumstances where the repaid capital was employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income</u>. Apportionment may be necessary where exempt income is also derived from the business activities.
>
> 14. The principle is the same as that which would apply to a replacement loan used to provide funds to meet a liability to a trade creditor or a lender of money where the relevant funds at the time of the replacement are being applied in the income producing business.
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> 15. <u>Similarly, interest on a borrowing by a company is likely to be deductible where the borrowing is used to fund the payment of a declared dividend (including a deemed unfrankable and unrebatable dividend paid from a "tainted share capital account" after 1 July 1998) to the shareholders in circumstances where the funds representing the dividend are employed as capital or working capital in the business carried on by the company for the purpose of deriving assessable income</u>. In circumstances where the liability to pay the dividend reduces the amount to the credit of the unappropriated profits account and the reduction is replaced in the company's accounts by the loan, there will usually be a nexus between the interest expense and the carrying on of a business for the purpose of deriving assessable income. (emphasis added)

In our view, without dealing with this issue, the interpretation of section 820-427A(4) given in the draft has the effect of applying a quasi-debt deduction creation rule (DDCR) to the TPDT directly counter to the explicit reference in the law that the DDCR does not apply to the TPDT in accordance with paragraph 820-423A(2)(g).

Part B: Commentary on schedules 3 and 4 of Draft PCG 2024/D3

Schedule 3

Scope of this schedule

As paragraph 218 of the draft PCG sets out, the TPDT was enacted on 8 April 2024 with retrospective effect. Given the first income year for many taxpayers concluded on 30 June 2024 with the draft ruling setting out the ATO's preliminary views and the accompanying draft PCG schedules being released for public consultation on 4 December 2024, further considerations must be given to the timeframe to which schedule 3 applies.

It is of course impossible for taxpayers to retrospectively restructure arrangements that now fall foul of the TPDT. As we noted earlier in this submission, the restructuring of these transactions is not straightforward and can take considerable time to implement. It has been put to the CTA that some restructures can take up to two years due to the varying compliance and governance milestones that need to be met. At present, the draft schedule limits changes to recourse arrangements to the end of the year in which the guideline is finalised (paragraph 225). We submit this period is too short.

For example, the removal of recourse by way of an amendment of loan documentation requires an extraordinary resolution of note holders of each affected Series of debt funding. In one taxpayer example, the Note Deed Polls require a majority consisting of not less than 75% of the votes cast, with a minimum attendance of loan note holders representing in aggregate at least 66% of the in principal amount of Notes when the vote is held. The taxpayer has 9 series of debt funding on foot that have been raised over the last 7 years with different maturities. Each series of funding may have up to 100 separate note holders. After the issue of the bonds, they are openly traded in the global bond market. There is significant practical difficulty involved in identifying the current bondholder and subsequently meeting the minimum attendance requirements to obtain majority consent to amend loan documentation for each Series of debt. Obtaining majority consent for each series of debt funding will take significant time and not be achievable if the PCG is finalised by 30 June 2025 based on the transitional period outlined in the draft PCG.

It is also unclear to us as to whether these guidance products will be finalised and published prior to an election being called when government departments enter a caretaker period. If the guidance product cannot be finalised and published whilst the ATO is under a caretaker period, it is possible that two full income tax years would have passed without any certainty being provided to impacted taxpayers.

As a practical solution, we recommend that paragraph 225 of the draft PCG be amended to state:

> *"The ATO will not apply compliance resources to income years ending on or before the finalisation of the draft ruling and PCG provided that going forward, taxpayers undertaking restructures of its financing arrangements consistent with low-risk outcomes outlined in examples 20 to 26 occur within that latter 18 months of the finalisation of the draft ruling and draft PCG or 1 January 2027."*

This would appropriately deal with the delayed finalisation of the draft ruling and draft PCG occurring weeks or even days out from the year ended 30 June 2025 – see the wording of paragraphs 225 and 251 which states *"… the end of the year in which this Guideline is finalised…*".

Restructures not attracting the application of Part IVA

Paragraph 221 of the draft PCG sets out, among other factors, that restructures should not attract the application of Part IVA, however, the draft PCG is not clear as to when the ATO may view Part IVA applying. This delineation is important given the new rules, the narrowness of the TPDT application and the types of financial restructuring now required.

For example, previously under the Arms Length Debt Test (**ALDT**), a taxpayer was able to claim all third party debt deductions provided that the debt deductions were up to the lower of the debt the notional Australian business would reasonably be expected to have borrowed, and the amount of debt a commercial independent lender would reasonably be expected to have provided. As a result of the law changes, this taxpayer can no longer claim third party debt deductions under the TPDT as it has a small foreign subsidiary that could be determined not to be minor or insignificant and would therefore be required to use the Fixed Ratio Test (**FRT**). The FRT results in some of its third party debt deductions in respect of its Bank and Bond debt being denied.

The taxpayer satisfies all other conditions of the TPDT but for the condition with respect to recourse to foreign assets due to the small foreign subsidiary. As a result, the taxpayer restructures its operations consistent with example 21 and can now access debt deductions using the TPDT which are greater than if the taxpayer relied on the FRT. Given the debt deductions are increased by the restructuring and a tax benefit is derived despite the taxpayer's actions being consistent with example 21 in the draft PCG, Part IVA should not apply.

We recommend that the ATO make it clear that it would not apply Part IVA to its own restructuring examples in the draft PCG.

Minor or insignificant

As we noted previously in this submission, further consideration needs to be given to how the ATO manages what is minor or insignificant in the context of a PCG. We acknowledge that this is complex given the limited legislative guidance other than the commentary in paragraph 1.30 of the Explanatory Memorandum.

In our view, paragraph 1.30 of the Explanatory Memorandum should be read together with paragraph 820-427A(3)(c) which suggests that you need to look at it in the context of the Australian assets that are available to the lender as recourse.

There appears to be little judicial commentary on what percentage would be minor or insignificant. In Case 21/96 heard by the AAT it was considered in paragraph 53 that 9% was significant:

> "The evidence is that whilst the time spent on this activity was relatively minor [note earlier in the judgement it was noted that the relevant time was around 1%] in comparison to that spent on the principals' countable activities, the use was frequent if not regular. Usage, in terms of time, at or before the assessable dealing of between 19% and 9% of one (sample) vehicle's time, in the opinion of the Tribunal, is neither ancillary to the countable activity use nor insignificant."

From the same year, in Case 2/96 regarding residual benefits for FBT purposes, the AAT also appeared to take the position that, out of a possible 500 taxi trips that an employee could take in one year, a total actual number of trips of 48 or less, could be considered minor. That is, a percentage of less than 10%.

There are also a number of cases concerning the use of "minor and insignificant" in relation to the old Bank Account Debits Tax but these do not mention a specific percentage. In terms of other Australian legislation, section 9 of the *Corporations Act 2001* defines a "substantial shareholder" as an entity that holds 5% or more of the total votes. Substantial is a synonym for significant and therefore, a minor or insignificant shareholder would be someone who holds less than 5%.

As such, we recommend that the ATO use a 5% threshold in paragraph 245 of the draft PCG which is more reflective of the wording 'minor or insignificant'. Such a threshold would also be consistent with *Draft PCG 2024/D4 Capital raised for the purpose of funding franked distributions - ATO compliance approach* which uses 5% as the threshold for which equity used to fund a dividend directly or indirectly is not substantial.

Schedule 4

We have no specific comments about Schedule 4 of the draft PCG.