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14 February 2025

Stephen Dodshon
Australian Taxation Office

By Email: *Stephen.Dodshon@ato.gov.au*

Dear Stephen

TR 2024/D3 – ASPECTS OF THE THIRD PARTY DEBT TEST

PCG 2024/D3 – RESTRUCTURES AND THE THIN CAPITALISATIONS AND DEBT DEDUCTION CREATION RULES

1. Thank you for the opportunity to provide comments on the Draft Taxation Ruling TR 2024/D3 ("**Draft Ruling**") in relation to the application of the third party debt test ("**TPDT**") in Subdivision 820-EAB of the *Income Tax Assessment Act 1997*[1] and Draft Practical Compliance Guideline PCG 2024/D3 ("**Draft PCG**") about restructures relating to the thin capitalisation and debt deduction creation rules.

2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many taxpayers that would be impacted by the ATO's interpretation of how the TPDT applies.

3. We welcome the ATO releasing detailed guidance on its interpretation of various aspects of the TPDT as well as practical solutions for administering the provisions in the initial years of their application. Many of the interpretations in the Draft Ruling and administrative practices in the Draft PCG are sensible and consistent with our understanding of the rules.

4. We note that there are certain aspects of the Draft Ruling that we believe require further explanation, examples or commentary to properly articulate the ATO view on key matters. We have highlighted these items in this submission. There are also aspects contained within the Draft Ruling that we do not agree with and believe that they may constitute positions that are unlikely to be upheld if there were to be challenged by litigation.

[1] All legislative references in this document are to this Act unless otherwise stated.

5. Accordingly, we urge the ATO to consider these aspects before finalising the Draft Ruling. These mainly relate to the concept of 'Australian asset' and 'commercial activities in connection with Australia'.

6. Many taxpayers will have already lodged their tax returns or will soon be lodging their tax returns for the income year ended 30 June 2024. The choice to make a TPDT election must be made by lodgment day (or a later day allowed by the Commissioner)[2] with a limited ability to revoke such election.[3] Given the complexity and the novelty of some of the key concepts contained in the TPDT, we believe that it is critical that the ATO adopts a transitional compliance approach during the first income year the TPDT is set to apply as many taxpayers will have had to make an election before the ATO finalises their view. We believe that this approach should involve both of the following:

   6.1. Allowing taxpayers to make a TPDT choice on a day later than lodgment day (e.g. via an amended income tax return). This day could be a reasonable period, say 90 days, after the day on which the Draft Ruling is finalised. This is particularly important given the retrospective compliance approaches provided for in the Draft PCG and the complexity of the thin capitalisation provisions. Taxpayers may seek to retrospectively make a TPDT choice for an income year after already having lodged an income tax return without having made the choice.

   6.2. Allowing taxpayers to satisfy the requirement that it be fair and reasonable to allow them to revoke the choice where it is doing so is response to the ATO's view in the finalised Draft Ruling. In particular, where a revocation is requested within a reasonable time after the finalisation of the Draft Ruling (e.g. within 6 months), the ATO should generally accept such revocations in the first income year for which the rules apply. There is a far smaller risk of taxpayers gaming the system by waiting up to 4 years to determine which of the three tests for general class investors provides the best result. A revocation requested shortly after the Ruling is finalised is a strong indicator that it is being done in response to views expressed in the Ruling.

7. Our submission contains our detailed comments about the Draft Ruling in Appendix A. In addition, Appendix B contains our comments about the Draft PCG which includes the recent additions of Schedule 3 and 4 as well as some further comments about the other Schedules of the Draft PCG.

8. We highlight that for the purposes of Division 30 of the *Tax Agent Services Act 2009* and, in particular, the amendments made to the Code of Conduct by the *Tax Agent Services (Code of Professional Conduct) Determination 2024*, all of the comments made in this submission are directly relevant to us as a firm and our clients. While this may result in a conflict of interest for the purposes of section 20 of the Determination, we highlight that we have tried to ensure that our comments and suggestions contained in this submission are balanced and consistent with the policy principles and intention of the rules as we understand them.

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[2] Subsection 820-47(2).
[3] Subsection 820-47(6).

If you would like to discuss any aspect of this submission, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely

A M KOKKINOS
Executive Director

APPENDIX A – DETAILED COMMENTS ON THE DRAFT RULING

9. Our comments in relation to the Draft Ruling follow the structure of the ruling (i.e. in the order that section 820-427A is written in).

Subsection 820-427A(1)

10. Following amendments to the definition of debt deduction in section 820-40,[4] it is no longer a requirement that a debt deduction be a cost that is incurred "in relation to a debt interest". However, this requirement is maintained for costs that satisfy subparagraphs 820-40(1)(a)(ii)-(iii). A straightforward interpretation of subsection 820-427A(1) is one that considers debt deductions covered by these subparagraphs as being attributable to the debt interests referred to therein.

11. The Draft Ruling should include a statement to this effect so that the nexus enquiry is effectively only a practical issue for subparagraph 820-40(1)(a)(i) debt deductions and that costs incurred in respect of subparagraphs (ii) and (iii) should generally satisfy this requirement.

Subsection 820-427A(2)

Effect of deemed attribution

12. As per paragraph 19 of the Draft Ruling, the purpose of this subsection is merely to deem a debt deduction (that ordinarily would not be attributable to any debt interest) as being attributable to a debt interest issued by the entity. There is a question of whether this deems there to be (1) attribution to an actual debt interest issued by the entity or (2) the deeming is to a hypothetical debt interest in order to allow the requirement in subsection 820-427A(1) to be satisfied.

13. The former view should be preferred, given the use of the definite article "the" in paragraph 820-427A(2)(a). That is, for the deeming to occur, the debt deduction must be to hedge or manage the interest rate risk of an actual debt interest issued by the entity. The deeming rule then treats that debt deduction as being attributable to that particular debt interest. If that debt interest satisfies the third party debt conditions, it follows that the debt deductions deemed attributable to it increase the entity's third party earnings limit for the income year.

14. In essence, the outcomes under the TPDT will be the same for debt deductions ordinarily attributable to a debt interest and those treated as being so attributable under subsection 820-427A.

15. The main outcome of this is that it is not necessary to consider subsections (3) to (6) of section 820-427A in respect of those debt deductions the subject of the deeming. Instead, the requirements of subsections (3) to (6) are only to be considered with

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[4] One of the effects of this amendment is stated in the Explanatory Memorandum to the amending Bill to bring costs incurred under an interest rate swap within the scope of the definition and therefore subject to denial under Division 820. We highlight that the ATO's views, as contained in Taxation Ruling IT 2050 is that such payments are not subject to interest withholding tax as they are not amounts of interest for withholding tax purposes (the definition of which includes amounts in the nature of interest). The removal of the requirement that a debt deduction must be a cost be incurred in relation to a debt interest issued by the entity cannot be the cause of the changed application of the law. Rather it, must be that payments under an interest rate swap are considered to be "economically equivalent to interest". While outside the scope of the Draft Ruling, we urge the ATO to clarify this interpretation in other public advice and guidance which explains its interpretation of the phrase "economically equivalent to interest" as it appears in the amended section 820-40.

respect to the relevant debt interest identified for the purposes of subsection (2). We suggest that the Ruling make this clear when finalised.

16. For example, one does not need to consider the 'recourse' requirement separately in relation to interest rate swap costs incurred by an entity, as recourse is only considered in for the debt interest for which those costs are incurred to hedge or manage the interest rate risk in respect of.

17. The requirement in paragraph 820-427A(2)(b) that the debt deductions must not be payable to an associate entity supports this interpretation as it should not be necessary to then further consider what is essentially the same 'third party requirement' as contained in paragraphs 820-427A(3)(a)-(b). Accordingly, we believe it would be useful for the ATO to clarify this point within the finalised Draft Ruling.

18. We also do not believe that creates an integrity risk with respect to the application of subsection 820-427A(2) (i.e. whether credit support rights can be incorporated into the swap, such as credit default swap rights). This is because the requirements of paragraph 820-427A(2)(a) limit the arrangement to one hedging or managing interest rate risk and not default or credit risk.

Paragraph 820-427A(2)(a)

Association with hedging or managing interest rate risk and the "to the extent" rule

19. Under accounting standards AASB 9 and AASB 139, hedge relationships do not need to be 100% perfect to comply as an effective hedge relationship (for example, refer to the hedge effectiveness range of 80–125 per cent in AASB 139). This allows the entity to qualify for hedge accounting (e.g. to record changes in fair value of the hedging instrument through profit and loss).

20. Section 230-365 in the Taxation of Financial Arrangements ("**TOFA**") rules defers to these standards in respect of the requirement that a hedging financial arrangement to which the TOFA hedging financial arrangement election applies to be one that is highly effective.

21. Practically, there will be situations where an entity will 'over' or 'under' hedge its interest rate risk under a debt interest (e.g. due to differences in the notional principal under the swap instrument and the actual amount of debt owed under the debt interest).

22. It could be argued that given the apportionment rule contained in subsection 820-427A(2) that to the extent the debt deductions payable under an interest rate swap are more or less than 100 percent effective, they are no longer considered directly associated with hedging or managing the interest rate risk in respect of the debt interest. We do not believe that this is the correct interpretation of the provision.

23. The ATO should clarify that all debt deductions payable under a swap agreement that turn out to be more or less than 100 per cent effective may nevertheless be considered to satisfy the requirement in paragraph 820-427A(2)(a). In particular, where the hedge is considered highly effective either for income tax or accounting purposes, there should be no partial denial of debt deductions to the extent of any over or under hedging.

24. Note that this would be consistent with the application of TOFA to hedging financial arrangements as outlined in paragraph 8.70 to the Explanatory Memorandum to the *Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008:*

> *8.70 Note, however, that if the hedge is highly effective but not 100 per cent effective, the ineffective portion is not treated differently by Subdivision 230-E. That is, unlike financial accounting, the ineffective portion of an otherwise highly effective hedging financial arrangement is not disqualified from hedge tax treatment under Subdivision 230-E.*

Net vs gross costs

25. Most swap contracts provide for net settlement payments to be made. We highlight that the default TOFA rules generally treat each leg of a swap agreement as a separate financial arrangement.[5] That is, the swap contract would generally give rise to gross assessable TOFA gains and gross deductible TOFA losses, rather than a net TOFA gain or loss.

26. The Ruling should clarify that it is the gross debt deductions that need to satisfy the third party debt conditions in order to be deductible if a TPDT election is made and clarify that these gross amounts are capable of satisfying the requirements in subsection 820-427A(2). That is, the gross TOFA losses can be considered to be associated with hedging or managing interest rate risk and can be considered to be paid or payable to an unrelated party. We expect that this should be the case, even though TOFA generally provides deductions for losses made from financial arrangements,[6] rather than for amounts paid, payable or otherwise incurred (being the language used in paragraph 820-427A(2)(b) and subsection 820-40(1)).

27. Providing a clarification of this kind can also put taxpayers on notice of the potential risk of making a TPDT election. For example, where not all the third party debt conditions are satisfied for a debt interest, this could result in both the ordinary debt deductions under the financial arrangement (e.g. floating rate interest paid under a loan) as well as the gross deductions under the interest rate swap (e.g. the fixed rate leg) being permanently denied, while the gross income received under the swap (e.g. the floating rate leg) may remain assessable.

28. For completeness, we believe that it is likely that this gross tax treatment applies under ordinary principles (i.e. to non-TOFA taxpayers) but this may depend on the terms of any swap agreement.[7] This is consistent with the view taken by the ATO in paragraph 4 of Taxation Ruling IT 2682.

29. As this can result in significant implications for taxpayers, we believe that it is important to highlight this outcome in the final Ruling.

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5 See section 230-120 which applies to arrangements with notional principal. Refer also to the example at the end of subsection 230-120(1).

6 Section 230-15.

7 While it may be common for the counterparties to the swap to settle the net difference under the swap in cash, the legal rights and obligations may be to receive and make gross payments such that amounts are derived and incurred on a gross basis under ordinary principles.

Paragraph 820-427A(2)(b)

On-swap by group financer

30. Example 1 of the Draft Ruling clarifies that debt deductions under an on-swap agreement cannot satisfy paragraph 820-427A(2)(b). While we understand that the Draft Ruling is not dealing with the application of the conduit financing provisions, we believe that it is important to highlight (e.g. by way of a footnote in the final Ruling) that this outcome does not change where the conduit financing conditions in section 820-427C are satisfied. That is, none of the modifications made by section 820-427B change the requirement in paragraph 820-427A(2)(b).

Subsection 820-427A(3)

Temporal aspects of the TPDT

31. Paragraphs 31, 33, 35, 98, 114 and 133 of the Draft Ruling provides guidance as to various temporal aspects of the TPDT that are otherwise not expressly clarified in the law. We agree with the views contained in each of these paragraphs, which we believe are sensible interpretations on these aspects.

32. We recommend that that the Ruling also address one further temporal aspect being the time at which an asset is considered to be an Australian asset. The Ruling should clarify whether an asset can commence or cease to be an Australian asset part way through an income year. For example, if the view is maintained that Australian shares may not be Australian assets due to the activities of the underlying company, it may be that the status of the shares fluctuates with changes to those activities.

33. The Ruling should clarify whether the status of an asset as an Australian asset can change over time and that, consistent with paragraph 35, the recourse requirement is tested by reference to the time during the year the debt interest is on issue (e.g. if the asset stops being an Australian asset after the debt interest ceases to be on issue, then this will not cause the condition to not be satisfied).

Paragraph 820-427A(3)(c)

Recourse is direct recourse

34. We believe that the proposed approach to be taken by the ATO in respect of the term 'recourse' (as it is used in the TPDT as set out in paragraphs 36 to 43 of the Draft Ruling) is sensible, being an approach to confine recourse to those assets available to the holder of the debt interest to satisfy liabilities owed to it. We do not believe it would be appropriate to 'look-through' rights to identify other assets held by other entities. With reference to cases such as *BHP Billiton Finance Ltd*,[8] we agree that this alternative view is unlikely to be a position that would be sustainable at law. Furthermore, we believe it would lead to extreme and inappropriate outcomes.

35. Example 2 contains a very sensible and helpful interpretation of the provision to clarify that one must look to actual assets held by the entity during the relevant testing period

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[8] In particular, the judgement by Gordon J in *BHP Billiton Finance Ltd v FCT* [2009] FCA 276, and the analysis of the meaning of 'recourse' at [206] ff.

rather than what hypothetical assets the holder of the debt interest may have recourse to.

36. We do however suggest that it is worthwhile to emphasise in the Ruling that recourse means direct recourse in this context and that it is to be contrasted with other provisions in subsection 820-427A(5) which refer to recourse being direct or indirect.

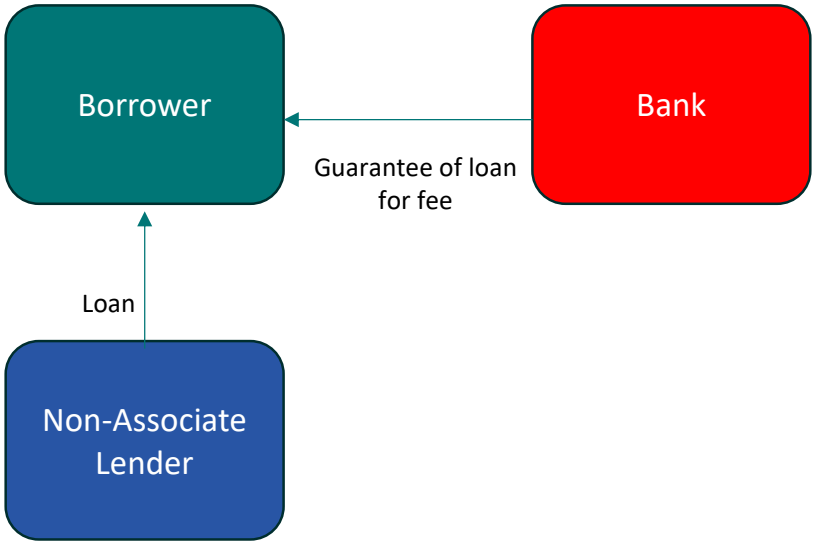
37. It is only where the holder of the debt interest has recourse to rights that are credit support rights this results in, what is in effect, an indirect recourse test where one must 'look-through' those rights in order to determine whether an exception contained in subsection (5) is available or not.

38. We have found that many may not currently properly understand the rules relating to credit support rights and will immediately turn to subsection 820-427A(5) when, for example, they are considering guarantees or security given for a borrowing directly to the lender. We do not believe that this approach is necessarily correct.

39. We believe it is important for taxpayers to properly understand the nature of the contract and whether the relevant guarantee or security or other agreement will give rise to an asset of the borrower (for paragraph 820-427A(4)(a) and (b) purposes), whether the arrangement will result in the guarantor or similar entity being an obligor (for paragraph 820-427A(4)(c) purposes), and whether the arrangement requires consideration of the credit support right provisions (for subsection 820-427A(5) purposes). We believe that these considerations may be getting conflated in practice and thus we believe it is important to step through this in the final Ruling.

40. In doing so, we believe additional explanations in the Ruling would assist in better explaining these subtle distinctions that relate to the recourse requirement. In particular, we would recommend that the ATO consider including two examples in the Ruling to assist taxpayers and advisers. We highlight that there appears to be no examples that directly cover the following two scenarios and outline exactly what occurs under subsections 820-427A(4) and (5). Accordingly, we believe that this represents a significant gap in the Draft Ruling. To the extent that the two scenarios result in a different outcome, it would be important for this difference to be outlined in the final Ruling.

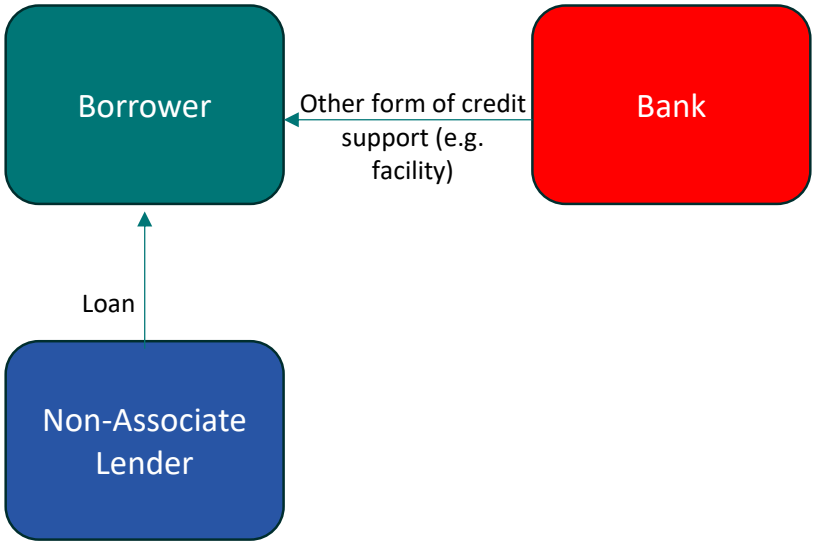
Example 1



41. In this first example, the borrower obtains a loan from an unrelated party and obtains a bank guarantee to support the borrowing, for which it pays a fee. Under the terms of the bank guarantee, where a default occurs the lender has rights to sue the bank to recover to amounts owed to it under the loan.

42. Assume that the bank is not related to the Borrower but holds foreign assets. We would request that the ATO explain whether subsections 820-427A(4) and (5) apply to this arrangement and in what manner.

Example 2



43. In this second example, he borrower obtains a loan from an unrelated party and obtains a letter of credit facility from a bank that allows the borrower to draw upon a facility (up to an agreed limit) for the purpose of satisfying its debts, which includes the loan provided by the Non-Associate Lender. This facility does not allow the Non-Associate Lender to sue the bank to recover amounts owed to it under the debt.

44. Assume that the bank is not related to the Borrower but holds foreign assets. We would request that the ATO explain whether subsection 820-427A(4) and (5) apply to this arrangement and in what manner.

Subparagraph 820-427A(3)(c)(ii) only covers rights, not expectations

45. We suggest that the Draft Ruling confirm that for the exclusion in subparagraph 820-427A(3)(c)(ii) to apply, recourse must be against rights held by the relevant entity. That is, they must be legally enforceable rights, rather than mere expectations.

46. For example, a loan contract may make provision that allows for an equity cure. That is, it allows the shareholder to remedy a default by the borrower of a term of the loan or a

debt covenant by injecting further equity into the borrower. However, as this remains a choice for the shareholder and not an enforceable right held by the borrower, this should not be considered a right covered under subsection (5). In fact, it should not be considered an asset at all of the borrowers. Ultimately, in this case, the shareholder may walk away and permit its subsidiary to default on the loan.

47. Regardless of the likelihood of the right of the shareholder to exercise its rights under the equity cure provision or the level of implicit support expected from parent entities, unless these are actual rights held by an entity, the Ruling should confirm that these are neither assets nor credit support rights held by the borrowing entity.

Recourse to trust assets

48. An entity that is a trust may be the issuer of a debt interest, or an obligor of a debt interest issued by another entity. When applying the TPDT to such debt interests, we believe that one needs to consider trust law concepts when considering the recourse requirement.

49. In accordance with PS LA 2012/2:

> *20. Only a legal person can owe a debt and be sued for it. A trust is not a legal person; it is a fiduciary relationship subject to which property is held. It is the trustee of a trust, being a legal person that can incur legal obligations such as debts and other liabilities for the purposes of the trust.*

50. The PS LA goes on to explain that in seeking a judgment against a trustee, a creditor (e.g. the Commissioner of Taxation) cannot enforce these directly against the trust assets:

> *58. You should be mindful that a common law judgment against a trustee for a sum or debt, whether incurred personally or as trustee, cannot be enforced directly by common law execution levied by the judgment creditor upon trust assets. However, we (along with other creditors of the trustee) are entitled to be subrogated to the rights of the trustee to indemnity out of the trust fund.*
>
> *…*
>
> *62. Subrogation is an equitable remedy by which rights are transferred from one person to another by operation of law. As an equitable remedy, it will only be granted in appropriate circumstances.*
>
> *63. The effect of the grant of a remedy of subrogation to us in a trust context is that we, along with other unsecured trust creditors of the former trustee, would stand in the shoes of the former trustee.*

51. The operation of trust law principles is such that recourse to assets of the tax entity that is the trust is only available to creditors by way of subrogation. This may present a difficulty in applying the recourse concept as the Draft Ruling concludes that a 'look-through approach' does not apply. That is, the only way recourse is available to trust assets is by 'looking-through' rights held by the trustee.

52. We suggest that the Ruling address this issue by covering the two most important situations involving a trustee. That is, where an entity acts in its own capacity, and where the entity acts in the capacity of a trustee. For the middle market, that operate

through trusts, we highlight that it is important that the final Ruling consider and comment on this issue.

53. The first situation is where an entity that acts as a trustee is the relevant borrower (or obligor) in its personal capacity. In such a case, the lender will have recourse to assets held by the trustee in its personal capacity. This should not include trust assets. While the assets held by the trustee on trust, or the right of indemnity of a trustee or former trustee in respect of that trust is an asset held by it, these assets and rights should not be considered ones for which a lender has recourse to for the payment of any amounts lent to the trustee in its personal capacity.

54. We note an exception not this is a right of indemnity that takes the form of a right of recoupment, as compared to a right of exoneration. This distinction is explained at paragraph 56 of PS LA 2012/2. Where a trustee has a right to reimburse itself from trust assets for expenses it has paid personally, this right of recoupment should be an asset that is considered available to the lender to satisfy the relevant debt interest. This is because that right is one that allows the trustee to use trust funds to satisfy its personal debts and can be distinguished with a right of exoneration which merely allows the trust funds to be applied to satisfy trust debts. However, the recourse should be considered to stop at this point (i.e. the right of recoupment) and not extend to the assets of the trust, consistent with the no look-through approach adopted in the Draft Ruling.

55. That is, even if the lender generally has recourse to all assets of the trustee, trust law principles should preclude recourse to the right of indemnity where the debt was not obtained in the proper course of administering the trust. As recourse to the trustee's assets being its right of indemnity is not available to a creditor that lent to the trust, it should be irrelevant whether or not the right of indemnity is considered a credit support right (even if it is, it is not one to which recourse can be had). As noted above, there is likely to be a different conclusion for rights of recoupment.

56. The second situation is where the entity being considered is the trust itself. In such case, it could be concluded that the holder of the debt interest has recourse to the trust assets, albeit recourse that is exercisable by way of subrogation to the trustee's right of indemnity. While a certain form of 'look-through' is required to reach this conclusion, it is not by looking through and beyond the assets of the trust, rather it is by looking directly at the asset of the trust, albeit via the right of indemnity held by another entity being the trustee (or former trustee).

57. The above also requires consideration of the reference to "entity" in section 820-427A and the meaning of an entity in section 960-100, in particular subsections 960-100(3) and (4). Taking the above into account, we believe that it is most likely the case that one must: (a) have regard to the liabilities of the trustee and the right of indemnity of the trustee in respect of a particular trust (rather than the actual assets of the trust); (b) allocate those items to the relevant trust entity in accordance with section 960-100(4).

58. This will give rise to questions as to whether the right of indemnity is an Australian asset (or whether one looks to the underlying assets).

59. Further, it is likely the case (unless otherwise stated in a loan agreement) that because the trustee is personally liable for debts incurred in its capacity as trustee the trustee (or former trustee) is a member of the obligor group in relation to the debt interest issued by the trust (as defined in section 820-49) such that it will need to be the case that (unless the right of indemnity is a minor or insignificant asset), the trustee needs to be an Australian entity and that the right of indemnity needs to be an Australian asset in

order for the third party debt conditions to be satisfied. If the ATO agrees with this view, this is important to include in the final Ruling.

Unsecured debt

60. The Ruling should provide additional clarity about how recourse is determined for unsecured loans. Paragraph 41 and example 4 merely re-state the general principle espoused in paragraph 36 that the unsecured creditor has recourse to the assets held by the borrower that are available in satisfaction or recovery of the amounts owed. It does not provide any practical application of this principle.

61. For example, if a secured creditor has a security interest (e.g. a mortgage) over Asset A, which may be foreign real property, does this mean that the unsecured creditor does not have recourse to Asset A where the terms of the unsecured borrowing do not otherwise limit recourse in any way? This could be a practical issue where a resident individual guarantees the debts of a company or trust (so that he or she becomes a member of the obligor group) and that individual also holds a foreign property subject to a mortgage. It would need to be considered what assets the entity that lent to the company or trust could have recourse to if the guarantee was called upon.

62. It may be that the value of Asset A is greater than the amount owed to the secured creditor such that the exercise of the secured creditor's rights would result in surplus funds available to satisfy debts owed to unsecured creditors so that it is considered that the unsecured creditor has recourse to Asset A.

63. By contrast, if the value of Asset A is less than the amount owed to the secured creditor at all times during the income year it, the final Ruling needs to be clear as to whether the unsecured creditor is taken to have recourse to Asset A for the purposes of the TPDT. We believe that including an example of this second scenario (with the ATO's view on this example) is important for the purpose of the example.

64. We recommend that the Ruling consider these scenarios in more detail when it is finalised. In reality scenarios are likely to be complex, such as the same creditor having security over multiple assets in respect of multiple debt interests from the same debtor. However, if a taxpayer can demonstrate that based on all the rights held by secured creditors, the amounts owed and the values of secured assets that the practical fact of the matter[9] is that an unsecured creditor could never have recourse to particular assets during the income year to satisfy or recover amounts owed to them, then we believe it should be reasonable to conclude that no recourse is available to those assets under paragraph 820-427A(3)(c).

Minor or insignificant assets

65. Further to the comments above regarding recourse to trust assets, the Ruling could also clarify when assets that are rights of indemnity are considered minor or insignificant. For example, an entity that is conducting a funds management business may also act as a trustee or responsible entity of a fund (established as a trust). Such an entity would hold rights of indemnity against trust assets where they have borrowed on behalf of the trust in accordance with the terms of the trust.

66. The Ruling should further clarify whether assets are considered on an individual or collective basis. Trading stock of an entity could comprise of millions of items, each of

[9] Paragraph 37 of the Draft Ruling states that the recourse requirement "is a practical question of fact".

which has a minimal or insignificant value. On one view, each such asset is a minor or insignificant asset that is excluded from the recourse requirement which may result (in an overall sense) of recourse being available to assets which collectively have significant value.

67. We note that this same issue will occur for many assets that have 'control' accounts, such as depreciable assets or trade debtors. For example, the trade debtors balance (which may be a significant balance), may comprise thousands of individual balances that are themselves minor or insignificant. Accordingly, we believe it is important for the final Ruling to clarify the ATO's view on this point.

Australian assets

General observations

68. Paragraph 82 of the Draft Ruling states that "the TPDT is designed to be narrow"[10], with reference to the Explanatory Memorandum (paragraph 2.92). We believe this is a reference to the requirements contained in section 820-427A (for example that recourse can only be had to Australian assets). This does not mean that every term used in section 820-427A needs to be interpreted narrowly. By contrast, the existence of the TPDT as an elective test may be viewed as a form of tax concession allowing entities to obtain debt deductions beyond what is available under the default fixed ratio test. The Impact Analysis contained in Attachment 2 of the Explanatory Memorandum states:

> *The third-party debt test was refined in response to this stakeholder feedback, expanding the conditions to accommodate most common financing arrangements. The intended outcome is that property and infrastructure entities can claim third-party debt deductions (such as bank debt), with no links to earnings, subject to satisfying test conditions (a set of restrictions intended to prevent an unlimited quantum of third-party debt replacing the existing related party debt, and to prevent debt dumping into Australia from offshore). This reflects the need to balance tax integrity with genuine commercial investments.*
>
> *The amendments to the third-party debt test recognise the role of external debt in funding real property developments and helps to mitigate any unintended impacts or uncertainty for future investments projects in Australia (including on related government policy, such as supporting investment into the build-to-rent sector), or transitional costs in applying the new rules.*
>
> *The third-party debt is test is specific to Australia, although though most countries have some form of bespoke arrangement for real property industries. For instance, Canada, the UK, and the US all provide some form of special treatment for real property projects.*

69. Given the TPDT was designed as a unique and bespoke test available only in Australia that goes beyond the OECD's BEPS Action 4 recommendations and intended to accommodate "most common financing arrangements" and "genuine commercial investments", aspects of the TPDT should be interpreted within that context. That is, if

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[10] This is also stated at paragraphs 4 and 106 of the Draft Ruling.

the TPDT is concessionary, it may be appropriate to interpret it broadly rather than narrowly.

Tangible and intangible assets

70. We agree with paragraphs 82 and 83 of the Draft Ruling that the physical location of real property and tangible assets should generally be determinative of whether an asset is Australian or not. The Draft Ruling could further clarify that certain moveable tangible assets would nevertheless be considered Australian assets if they are located outside of Australia temporarily. This would mean that an asset can still be considered Australian where it is being delivered to Australia from overseas, where title to those assets have passed before they have entered Australia.[11] Alternatively, if an asset is a tangible asset and is only considered Australian once it enters Australia, any temporary location outside of Australia should be considered minor or insignificant.[12] Likewise, as an example, if an employee were to take a 'laptop' computer on an overseas trip, the asset should not be considered a foreign asset or something that would render the test as not being satisfied. We believe that it is important for the Ruling to clarify this aspect.

71. Without a clear statutory definition of "Australian asset" the most difficult application of this provision is in relation to intangible assets.

72. We do not agree with the view that only a tenuous or remote connection to another jurisdiction is permitted for an asset can be considered an Australian asset. In particular, this may render the TPDT inapplicable to genuine Australian businesses who have foreign customers. For an asset such as a loan receivable or trade receivable from a foreign entity who obtains goods or services from an Australian business, it may be difficult to conclude that the receivable only has "a tenuous or remote connection" to the foreign jurisdiction. This will be the case for other contractual rights entered into with foreign counterparties.

73. The Draft Ruling is somewhat helpful in stating at paragraph 85 that "it may weigh in favour of the asset being an 'Australian asset'" where the asset generates or could generate assessable income. However, we believe the Ruling should go further by stating that there will be a general presumption that where the asset solely generates income from Australian sources that it will be considered (or the ATO would consider that the asset should be treated as) an Australian asset. By including this in the Ruling, taxpayers would have some comfort of a bright line test for certain intangibles such as loans to non-residents, where such items generate Australian sourced interest income. We believe that there is a significant body of case law that can assist taxpayers in determining the source of income and thus a bright line rule in the Ruling will provide more certainty to taxpayers.

74. Given that Australian residents are assessed on worldwide income, we agree that merely generating assessable income does not necessarily suggest anything about the nature of the asset. Instead, the generation of Australian sourced income is a better indicator of whether the asset is an Australian asset. Further, this approach does not undermine the integrity of the rules as it would only allow the TPDT to apply to third

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[11] By way of example, subsection section 40-150(3) of the *Income Tax (Transitional Provisions) Act 1997*, adopts a "reasonable to conclude test" for the Australian asset requirement for the purposes of the temporary full expensing concession which looks at where the asset is to be principally used or located.

[12] While the provision is phrased in a way that requires the assets themselves to be minor or insignificant, this would be a sensible compliance approach needed to balance out an overly narrow view as to the meaning of Australian asset.

party borrowings that are supported by income over which Australia will have the primary taxing rights.[13]

75. Such an approach would place focus on the where the activities generating the income occur and are consistent with the object of the TPDT to support genuine debt-funded commercial operations in Australia. This is more appropriate than an approach that looks at the identity of the counterparty as suggested in paragraph 84, which refers to "rights against foreign-resident entities". Firstly, taxpayers generally do not know and are not expected to know the residency status of entities they contract with. Secondly, this places the emphasis on the wrong subject matter. By way of an example, an asset could be the development rights in respect of a construction project. It should be the case that the location of the project, which is likely to align with the source of the income, is determinative. That is, rights against a foreign entity to develop land they own in Australia should be Australian assets while rights against an Australian entity to develop land they own overseas should not be an Australian asset. We believe that the residency status of the counterparty is irrelevant to this consideration. This should similarly be the case for exporters of goods as it should be that one looks to the source of the income, rather than identity of the customer.

Equity interest and debt interests

76. We observe that the Draft Ruling states that a 'look-through' approach does not apply under the recourse requirement, but this approach is contradicted by a look-through approach that appears to have been adopted in interpreting the meaning of Australian asset. Given that the Australian asset requirement is merely a sub-category of the recourse requirement, this effectively means a look-through approach is being applied when considering the TPDT.

77. For assets such as equity and debt interests in other entities, the key test should be the asset's connection to the entity's Australian activities rather than consideration of the asset in a vacuum. That is, the same asset may be an Australian asset in one entity's hands but not an Australian asset in another entity's hands. This is consistent with how tangible assets are treated. The exact same item of inventory could be an Australian asset of an Australian business and a non-Australian asset of a foreign business. Similarly, identical rights under a loan against an identical borrower may be an Australian asset of an entity conducting a lending business in Australian but not an Australian asset if it were held by an entity conducting a foreign lending business outside Australia. This is regardless of where the denomination of the loan.

78. An entity may conduct a share trading business in Australia, part of which involves trading in overseas equities. By way of example, the business may trade shares in Apple Inc. Such shares, despite being shares in a US company, listed on a US stock exchange, with the underlying activities of the company being carried out outside Australia should nevertheless be considered an Australian asset due to its use in the Australian share trading business. However, an identical share in Apple Inc should not be considered an Australian asset of a share trading business carried on outside Australia.

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[13] We note that for assets such as loans to non-residents, that the foreign jurisdiction will generally have taxing rights under an interest withholding tax, but this does not mean that the interest income being derived is from foreign sources as for income of this kind the right to tax foreign resident entities usually results from the location of the payer rather than the source of the income. The right of foreign jurisdictions to apply withholding taxes on certain kinds of income derived by Australian entities should not be taken to mean that the asset generating that income is not an Australian asset.

79. This approach that looks at where the asset is being used or exploited is preferable to one that determines that status of an asset absent of the context in which it is held.

80. For these reasons we do not agree with the approach adopted in the Draft Ruling which concludes that the following are not Australian assets for the purposes of the TPDT:

    80.1. all shares in a foreign resident company are not Australian assets;

    80.2. all bank accounts (without more) held with a foreign (even if they are kept to facilitate the sale of Australian products of an Australian business);

    80.3. shares in Australian companies with an overseas permanent establishment.[14]

81. We further highlight that we do not believe that ATO view is likely to be sustainable in examples such as Example 13. Assume this example were modified such that there were ten Australian incorporated resident companies interposed between Head Co and Sub Co (all holding entities only with no other assets) and that only the shares in the first interposed entity (InterCo1) owned by Head Co were used as security for the relevant borrowing. We do not believe that a court would hold that the shares in InterCo1 (being an Australian incorporated company holding shares in another Australian incorporated company) would be regarded as a foreign asset simply because Sub Co holds (predominantly) foreign assets. While this may give rise to an integrity risk, we believe that this view is unlikely of being upheld and that the ATO would need a legislative change to be able to adopt this view (i.e. similar to an indirect test contained in paragraph 820-427A(4)(b)).

Credit support rights

82. Regarding credit support rights, where these support a receivable or similar right of the relevant entity (as per example 6 of the Draft Ruling, where they support the rights of a lessor), if the right being supported is an Australian asset it should follow that that the credit support right is also an Australian asset. Where the credit support right supports a liability of the entity (as per example 7), the credit support right should be considered an Australian asset if the liability is incurred or obtained in the course of the entity's Australian operations.

No guidance on paragraph 820-427A(4)(b)

83. The Draft Ruling does not provide any guidance as to how the ATO will apply the 'indirect rule' in paragraph 820-427A(4)(b). The Ruling should explain what comprises a direct or indirect legal or equitable interest in an asset. This could involve explaining whether or not indirect interests are only limited to indirect ownership interests only, so that the rule only requires tracing through legal form shares or units rather than debt-like interests or other contractual rights.

84. Further, the Ruling should explain the interaction of this provision with the 'minor or insignificant' exception. For example, the value of any entity's interest may be minor or insignificant but the value of the underlying assets in which there is an indirect legal or equitable interest may be substantial. This could be the case where the entity that issued the debt interest (and provided security for the debt over shares or units in itself) holds some shares in an ASX-listed company which has overseas operations. While

[14] If, contrary this look-through approach is adopted, the Ruling should also conclude that shares in a CFC could be Australian assets if the CFC's activities primarily consist of carrying on a business through an Australian permanent establishment.

the shares in the company may be considered Australian assets, the issuer of the debt may be considered to have an indirect interest in material non-Australian assets.[15]

85. A strict reading of the provision may conclude that the 'minor or insignificant' exception is not available because the assets are not insignificant, even though the interest in the assets are. It may therefore be preferable to interpret the term "legal or equitable interest" in paragraph 820-427A(4)(b) in a way so that it only applies to interests in assets that amount to interests over which the entity can exercise control.

86. In *Craig v FCT*,[16] the High Court stated:

> *The word "interest" is not a technical term: the law does not give the word the same specific application in all contexts in which it is used. In Attorney-General v. Heywood, it was said that "the word interest is capable of different meanings, according to the context in which it is used or the subject-matter to which it is applied."*

87. In our view, it would be an absurd reading of the Act if a small investment in another Australian company (that holds significant Australian and non-Australian assets) would result in the third party debt conditions not being satisfied in respect of a debt interest over which an entity grants to the holder of the debt a security over its own membership interests. It may even be the case that the issuer of the debt interest expressly prohibits recourse for payment of the debt to its investment portfolio.

88. Merely being the holder of an indirect legal or equitable interest in a foreign asset appears to result in the conditions being failed. By way of an example, assume that Aco holds shares in an ASX-listed company. If Aco were to grant direct recourse to all of its assets including the shares in the ASX-listed company (but not grant recourse to the membership interests of Aco), we believe that the ASX-listed shares may be considered Australian assets. However, if instead, Aco were to grant recourse to the shares in Aco instead, a view that there is a lack of a general prohibition on holding indirect legal or equitable interest in foreign assets (i.e. the prohibition only applies in a paragraph 820-427A(4)(b) scenario) would result in a conclusion that the lender has recourse to interests in an entity that holds foreign assets (even though the borrower does not legally or technically hold such recourse).. Such a view would result in absurd outcomes.

89. Under the current drafting, we believe that a sensible application of the law could result from interpreting the phrase "legal or equitable interest, whether directly or indirectly" in a narrow way that does not immediately cause the conditions to be failed as soon as any ownership interest is held in any entity for which one could look through to find a foreign asset. That is, the interest should be such that control can be exercised over that asset and thus the lender can have recourse to such assets (either legally or equitably via the indirect ownership). We believe that this is a significant issue to deal with in the final Ruling.

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15 Arguably, it may also be irrelevant if the indirect interests are to minor or insignificant assets as the 'minor or insignificant' qualifier may only apply to the assets to which the creditor has recourse to, and not the assets which the issuer holds legal or equitable interests in.

16 [1945] HCA 1.

Interaction between paragraphs 820-427A(4)(b) and (c)

90. We highlight that in order for paragraph 820-427A(3)(c)(i) to be satisfied, the Australian assets to which the holder of the debt interest can have recourse to must be those covered by at least one of the paragraphs in subsection 820-427A(4).

91. Certain assets may satisfy both paragraphs 820-427A(4)(b) and (c). Membership interests in the borrower may also be asset of an Australian entity that is a member of the obligor group in relation to the debt interest. For obligor entities that are Australian entities, this will always be the case where it provides recourse for the borrowing over any other assets other than membership interests in the borrower.[17] The Ruling should clarify that in such cases that both paragraphs are satisfied.

92. The Ruling could clarify that the holder of the membership interest of the borrower (without more) does not become a member of the obligor group in relation to the debt interest. This has the consequence that holder of the membership interest cannot be deemed to have made a choice to apply the TPDT.

93. Importantly, the Ruling should also confirm that where paragraph 820-427A(4)(c) is satisfied in respect of the membership interests in the issuer that it is not necessary to consider whether the issuer of the debt interest holds any legal or equitable interest in a foreign asset. Additionally, if the immediate owner of the borrower entity (referred to as "Head Co") also provides security over its own membership interests in respect of its subsidiary's borrowings, that only paragraph 820-427(4)(c) can be satisfied and not paragraph (4)(b) because the membership interests are not in the borrower itself, but in the membership interests in another entity (i.e. Head Co, being one level above). Therefore, the resultant application of the provision means that one need not consider what assets Head Co has a direct or indirect, legal or equitable interest in, but one most consider which entity or entities hold membership interest in Head Co and that these membership interest need to be Australian assets and the entities holding them need to be Australian entities in order for the third party debt conditions to be satisfied.

94. These clarifications could take pressure off taxpayers and relieve them of the need to consider this issue discussed above. Given that parent entities commonly provide security over their subsidiary's borrowings, highlighting this interaction would assist such groups in applying the TPDT.

Interaction between tax consolidation and paragraph 820-427A(4)(b)

95. Using the example above, a subsidiary of a tax consolidated group Sub Co (being the legal borrower) may offer its shares as security to the lender. Under the single entity rule, the Head Co will claim a tax deduction and thus may be taken to be the borrower (for example when applying Division 974. Accordingly, paragraph 820-427A(4)(b) could be interpreted as a reference to the membership interest in the Head Co when applying the single entity rule (as it may be regarded as the "entity" referred to in subsection (4)). Alternatively, the single entity rule could be applied in respect of paragraph 820-427A(4)(b) such that the shares in the Sub Co are not taken to exist. We believe that it may be open for such an interpretation to be taken.

96. We do not believe that the view outlined above is the better view and thus we believe it is important for the ATO to state its position in respect of this issue. We highlight that

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[17] See subsection 820-49(3).

the view above does not appear consistent with the ATO's view on the application of the single entity rule contained in TD 2004/47, where at paragraph 5 the ATO state.

> *5. This is because although the single entity rule treats subsidiary members of a consolidated group as parts of the head company (and not separate entities) for income tax purposes, it does not apply to defeat a clearly intended outcome under provisions outside the consolidation rules (such as Parts 3-1 and 3-3 of the ITAA 1997). In such cases, intra-group interests, or legal entities that are part of the head company for consolidation purposes, require a level of recognition in applying provisions that have regard to such interests and entities (for example, in determining eligibility for a concession). Paragraphs 8(c) and 26 to 28 of Taxation Ruling TR 2004/11 explain the Commissioner's view that reading the Act as a whole achieves this outcome (and without the need to rely on section 701-85 of the ITAA 1997).*

97. While the TD does not utilise section 701-85 for this purpose, believe that a similar outcome would occur through the application of section 701-85 if it could not be reached on a basic application of the single entity rule. Given the above, we believe it is important for the ATO to outline its view of the application of the single entity rule where security is provided over the shares of a subsidiary member of the group (where that subsidiary is the legal borrower or another subsidiary member is the borrower).

Examples 12 to 14

98. As outlined above, we do not agree with the look-through approach the Draft Ruling adopts in considering whether or not shares are Australian assets. Despite this, we make some suggestions regarding Examples 12 to 14 on the premise that the conclusions regarding Australian asset are correct.

98.1. Example 12 – The example could clarify that given Head Co has provided security over its own shares, that the holders of those interests (without more) are not considered members of the obligor group in relation to the debt interest, it is irrelevant whether such holders are Australia entities or not and that paragraph 820-427A(4)(b) is satisfied because Head Co is not considered to have a direct or indirect, legal or equitable interest in any assets that are not Australian assets. The current example only focuses on the shares in Sub Co and thus the "direct asset" rule. However, it should focus on all three tests (i.e. paragraphs 820-427A(4)(a), (4)(b) and (4)(c)) and state the conclusion under each.

98.2. Example 13 – The example is not particularly useful as the Bank's direct recourse to the assets of Sub Co (which is an obligor entity in relation to the borrowing) means that the third party debt conditions are not satisfied for this reason alone. It is not necessary to also consider whether or not the shares in Sub Co are Australian assets. Instead, the example would be improved if the Bank did not have recourse to the assets of Sub Co. If this were the case, whether or not the shares in Sub Co are Australian assets takes on greater importance. Further, the example could also address whether the shares in Head Co would cause the conditions to be failed. It may be that shares in Sub Co are considered Australian assets (e.g. because Sub Co's overseas permanent establishment is not material compared to its Australian business) but Head Co is nevertheless considered to have an indirect interest in those foreign assets being used in the overseas permanent establishment. The example could also go to state that if the members of Head Co provide

recourse to other assets of theirs, then it will be necessary to consider if those other assets are Australian assets and those members are Australian entities, but not necessary to consider whether Head Co holds a direct or indirect interest in a foreign asset. Given how wide the security net is case in this example and given that the example would fail the conditions in paragraph 820-427A(4)(b), we believe it is important to outline all tests in the conclusion (rather than focusing only on the direct shares held by Head Co).

98.3. Example 14 – Similar to our comments above, it is not particularly helpful that the Bank has recourse to the assets of the CFC (which presumably are not Australian assets). This fact alone renders the rest of the analysis irrelevant. The example should be altered so that it instead turns on whether the shares in the CFC and Sub Co are Australian assets. Our comments regarding example 13 are also applicable as, depending on the first conclusion reached, it may be necessary to consider whether Head Co is considered to have an interest in a foreign asset or whether the owners of Head Co provide recourse to any of their other assets.

Subsection 820-427A(3)(d)

Commercial activities in connection with Australia

99. We reiterate our comments above regarding the comments at paragraph 68 in the Draft Ruling about interpreting the TPDT narrowly. We do not believe that this requires the ATO to interpret all words in the provisions in a narrow manner.

100. While we agree that the breadth of the words 'in connection with' will depend upon the statutory context they appear in, Attachment 2 of the Explanatory Memorandum highlights that the TPDT is intended to assist in the use of external debt to fund certain projects that may not amount to a business including, expressly a build-to-rent project. A special purpose fund may be established to hold a single build-to-rent property and this may be viewed as a passive investment rather than an "Australian business operation". Paragraph 106 of the Draft Ruling states that the TPDT operates to accommodate capital intensive sectors with long investment horizons. As it is common for a project's assets to be held separately from its operations (e.g. a stapled structure), the Draft Ruling should not be seen as imposing a requirement that the entity seeking to apply the TPDT in respect of its borrowings carries on an active business. We believe such an approach would be inconsistent with the legislative intent of the TPDT in respect of such arrangements.

101. Further, we note TR 92/3 which considers the impact of the *Myer Emporium* High Court decision in which it was held that transactions entered into in carrying out a business operation or commercial transaction constitute the ordinary income of an entity that makes a profit from an isolated transaction. This further emphasises that a "commercial transaction" or "commercial activity" does not need to be one that is entered into in carrying on a business.

Holding direct and indirect interests

102. Another principal of statutory interpretation is that provisions should not be read in a way that renders language used by Parliament otiose. We highlight that for the exclusions in paragraph 820-427A(3)(d) to have work to do, the words 'in connection with' must be read broadly enough so that the business carried on through an entity's overseas permanent establishment and the entity's holding of debt or equity in a

controlled foreign entity can actually be considered to be 'commercial activities in connection with Australia'.

103. For this reason, we believe the conclusion in example 15 is incorrect. If the facts were changed to remove Target Co from the structure, so that the borrowed funds are used to directly fund the acquisition of Target Sub Co, then presumably the Draft Ruling would lead to the same conclusion (i.e. that the proceeds of the loan are not used to fund Bid Co's commercial activities in connection with Australia). As explained above, this would render the exclusion in subparagraph 820-427A(3)(d)(ii) otiose as there would be no need to have the express exclusion of holding controlled foreign entity equity. The better view is that the holding of shares in an Australian company that holds Australian assets which is anticipated to make assessable distributions to its Australian shareholder should be considered to be a commercial activity in connection with Australia. The lack of any 'indirect rule' in paragraph 820-427A(3)(d) should not mean that the paragraph should be read in such a way that using funds to holding interests in entities that have indirect interests in foreign business activities means that this kind of activity is not considered a commercial activity in connection with Australia.

Types of activities

104. The breadth of the phrase 'commercial activities' should also mean that restrictions should not be read into the provision that are not present in the words of the statute, or even alluded to in the Explanatory Memorandum, such as those mentioned in paragraphs 103 and 107 of the Draft Ruling, relating to capital management activities.

105. The provision does not use restrictive language, such as 'core' or 'main' or 'principal' commercial activities. The commercial activities of an entity should be understood to include any ancillary or supporting activities to the main commercial activities. Where certain costs that require funding are a natural incident of an entity's commercial operations, the borrowed money should be considered to fund commercial activities. This is preferable to a strict approach that requires tracing of funds and an artificial of delineation of an enterprise's activities into 'commercial activities' and non-commercial activities.

106. We highlight that Parliament has recently made it clear that funding of certain capital management activities results in adverse tax consequences. This includes section 207-159 dealing with the raising of equity to fund franked distributions and the debt deduction creation rules dealing with the use of related-party debt to fund various kinds of distributions. If Parliament wanted to further restrict capital management activities by denying debt deductions for the use of third party debt to fund such distributions (for entities seeking to apply the TPDT) then this intention could clearly have been conveyed if it wished.

107. It is a common feature of an infrastructure, development or build-to-rent project that the entity owning the asset periodically returns capital to investors to maximise their return on investment. It is also common that the entity does not wait until it realises the asset to do so and instead borrows against increases in the value of its assets in order to free up cash for investors. An ordinary commercial transaction in this sector should not be on that is considered not to be a commercial activity.

108. Further, we do not believe that paragraph 820-427A(3)(d) should be read in a way that artificially splits the composite term 'commercial activities in connection with Australia'

into two separate terms being 'commercial activities' and 'in connection with Australia'.[18] A natural reading of the provision is one that should result in emphasis being place on 'Australia' rather than 'commercial activities'. That is, the borrowed funds should be used in respect of the domestic operations rather than in the foreign operations. That is the key distinction that the provision is seeking to make, rather than trying to create a distinction between commercial and non-commercial activities. As a general rule, the use of debt to fund costs that are not commercial activities are not deductible under section 8-1 in any case.

109. We highlight that the view provided by the ATO will make it difficult for the ATO and taxpayers to be able to identify whether the funding meets the "commercial activity test", while the alternative view offered will simply require one to apply the nexus test in section 8-1 and then determine the extent to which the nexus is with the Australian commercial operations. We reference to cases such as *Kidston Goldmines*,[19] which outlines this type of analysis.

> *36. In most cases, the purpose of the borrowing will be ascertained from the use to which the borrowed funds were put; in Munro a non-income producing use. Where the funds are employed in a business devoted to assessable income, it may be said that monies borrowed to secure capital or working capital will be clearly deductible: The Texas Co (Australasia) Ltd v Federal Commissioner of Taxation (1939-40) 63 CLR 382 at 468 per Dixon J. If the business is devoted to the gaining of both assessable income and exempt income, some part of the interest outgoing will be deductible and it will be necessary to carry out a fair and reasonable apportionment of the interest outgoing.*

110. We strongly urge the ATO to reconsider its interpretation of this provision. While it is somewhat helpful that costs such as borrowing fees may be accommodated by the requirement that only "substantially all" of the proceeds of issuing the debt need to be used to fund the permitted activities, it may not always be the case that such costs are 'minor' or 'incidental' or 'nominal' as described in paragraphs 101 to 103 of the Draft Ruling. For large loans, borrowing costs such as establishment fees would rarely meet the description of 'nominal'. Borrowing costs should simply be considered costs incurred as part of the ordinary commercial activities of an entity. Where the commercial activities are conducted in Australia, then paragraph 820-427A(3)(d) should be satisfied.

111. The definition of the word "fund" when used as a verb is "to provide money for something" or "provide with money for a particular purpose". When a borrower obtains a loan to fund its ordinary business operations, any use of those proceeds to pay borrowing costs or capital management activities can be said to fund the underlying operating activities of the borrower, albeit in an indirect sense. We note that paragraph 107 of the Draft Ruling recognises that indirect use of proceeds can be considered. It should therefore also be the case if the immediate use of proceeds, such as the payment of an establishment fee, is one that enables the entity to carry out its commercial activities, the proceeds used to pay the fee should nevertheless be considered to funding those commercial activities.

112. We highlight that if this approach were not adopted, then any refinancing of previous debt would appear to automatically fail this requirement as the immediate use of

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18 In *XYZ v The Commonwealth* [2006] HCA 25, Gleeson CJ stated at [19]: "*There are many instances where it is misleading to construe a composite phrase simply by combining the dictionary meanings of its component parts*".

19 *Kidston Goldmines Ltd v Commissioner of Taxation* [1991] FCA 351.

proceeds would be said to repay principal and/or interest owing on a loan rather than to fund activities of any other kind. We do not believe the ATO can take a view that results in refinancing of debt being different to the payment of distributions in this provision. In both cases, the proceeds should be considered to fund the underlying operations or activities of the entity, rather than the immediate use to which they are put. Even if the proceeds are considered, in a sense, to fund both things, the provision does not state that the proceeds cannot be funding anything else other than commercial activities in connection with Australia. In either case, we submit it is critical that the Ruling explain the ATO's view regarding refinancing and whether third party borrowings that refinance older debts can satisfy the "commercial activities" requirement.

Trust distributions and capital management activities

113. Taking our proposed alternative approach specifically deals with transactions such as returns of capital and trust distributions. For example, TR 2005/12 provides that such amounts will have a "nexus" with the business and thus will be deductible under section 8-1 where there is a refinance of a "returnable amount" as defined in that ruling. We highlight that (first and foremost) a borrowing to fund a trust distribution may not be deductible under TR 2005/12 where such conditions are not satisfied. Accordingly, Example 16 can be misleading (as it presumes that the amount will be deductible and thus subsect to section 820-427A, which may not be the case).

114. To the extent that the borrowing funds a returnable amount, TR 2005/12 is clear that the actual funding will have a nexus with the relevant business of the trust. We have highlighted paragraphs 12 and 21 (in particular) and we also make reference to the principles in *Roberts & Smith*[20]

> *12. There may be practical difficulties in establishing that an amount was used to produce assessable income, particularly where funds are mixed7 and a portion of the funds is used to gain exempt income, is used for private family purposes,8 or is otherwise used in a non-income producing way. However, a rigid tracing is not necessary where all the funds have been used as part of the recurrent operations of the business of the trust estate.*
>
> *…*
>
> *21. It will not always be a simple matter to determine which of the two possible outcomes (deductible/non-deductible) arises in any particular case. Ultimately this question can only be answered by determining the objective purpose of the trustee in borrowing the funds. To the extent that the objective purpose of the trustee was to replace an amount that had previously been provided to the trustee by, or on behalf of, a beneficiary of the trust estate, and had previously been used in an assessable income earning activity, or business, carried on by the trustee in the relevant capacity, then the principle set out in Roberts & Smith will apply.*

115. Accordingly, we do not believe that the view offered by the ATO in Example 15 in the Draft Ruling is likely to be a sustainable view. We believe that if a taxpayer can demonstrate that the borrowing has funded the business operations (as required by TR 2005/12) and that the business operations are Australian operations, this requirement will be satisfied. To the extent that the amount is not a returnable amount or one that

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[20] *Commissioner of Taxation v Roberts, J.D. Commissioner of Taxation v Smith, V.R* [1992] FCA 543.

has a nexus to non-assessable non-exempt income, section 8-1 should deny a deduction.

116. It is only to the extent that the trust has mixed operations (see *Kidston Goldmines* referred to earlier), that we believe that the Australian commercial activities test is unlikely to be satisfied.

Substantially all

117. The Ruling should state that the phrase "substantially all" allows one to consider amounts in a relative sense. For example, for a $100 loan, if $99 of the loan were used to fund foreign activities then it should not be concluded that the use of only 1% of the borrowed funds for Australian commercial activities means that substantially all of the funds were so used merely because $99 is a minor amount that can be disregarded. For a $100 million loan, the use of only $99 of the borrowed funds for foreign activities should clearly be permitted under the TPDT if 99.999% of the borrowed funds were used to fund Australian commercial activities.

Subsection 820-427A(5)

Credit support rights

118. Subsection 820-427A(5) covers rights under or in relation to a guarantee, security or other form of credit support. It would be useful if the Ruling could provide an explanation or an example of rights that are only considered as being 'in relation to', but not 'under', one of the forms of credit support mentioned in the subsection. All the examples in the Draft Ruling appear to involve rights that would be considered to be under guarantees or other forms of credit support. Without any examples or any commentary, it is unclear as to how broad those words are and what rights would be encapsulated that are not (otherwise) those that are "under" such an arrangement.

119. We also suggest that the Ruling provide comments or provide examples about the references to 'directly or indirectly' in subsection 820-427A(5). In particular, those in ss 820-427A(5)(a)(i), (ii) and (5)(b). We highlight that in the latter two of these three provisions, that there is also a 'reasonably be expected to allow' test. It would be beneficial if some comments are provided on the application of these words in the final Ruling.

120. As discussed above, the Draft Ruling's approach to recourse is one that is limited to direct recourse, without 'looking-through' rights. It is important that the Ruling clarify whether the three provisions outlined above mean that indirect recourse allows for a look-through approach being adopted (and what the reference to indirect means in those tests).

121. Examples 17 and 18 in the Draft Ruling include credit support rights provided by third parties, being Bank and Head Co respectively. The credit support rights would appear to provide the holder of those rights direct recourse to Bank and Head Co. However, those entities may hold assets that themselves consist of rights against other entities (e.g. trade receivables, loan receivables, other credit support rights, equity interests, etc).

122. The examples conclude that the exception in subparagraph 820-427A(5)(a)(ii) is satisfied, but it does not explain how this conclusion is reached. For example, does this require the borrower to consider whether any of its associate entities have any liabilities

owing to the provider of the credit support right. If in Example 17, Electric Co had an associate entity that took out a loan from Bank would it be considered that Electric Co has credit support rights that could be exercised in a way that would allow recourse for payment to the assets of its associate entity (i.e. in exercising its rights against Bank, it may have further or indirect recourse to assets of its own associate entities).

123. We believe the provision should not be interpreted so broadly, as this would make it unworkable in practice. Where credit support rights are held against a large bank, this could lead require tracing to millions of further rights held by the bank (i.e. recourse against each of its borrowers), with further tracing through rights held by any of the bank's borrowers, and so on, with hypothetical indirect recourse almost being infinite. Instead, indirect recourse should only be considered where under an arrangement, an entity is interposed between the holder of the credit support rights and the ultimate in-substance provider of that credit support. We recommend that the final Ruling make this clear.

124. Taking Example 17 further, it would not be reasonable to expect that Electric Co would have recourse beyond the assets of Bank when exercising its rights under the bank guarantee. That is, it is expected that it will simply be repaid in full by Bank when it is able to call on the guarantee. It would only be in extreme circumstances where one would conclude that Electric Co would need to exercise its rights in such a way that would require it to further exercise rights against further parties (e.g. by winding-up or taking control of Bank). Accordingly, we believe that our recommended approach is one that should be adopted in the final Ruling.

125. Perhaps in Example 18, if Head Co was an entity of little substance that is merely a conduit, then indirect recourse beyond Head Co should be considered. For example, Head Co could hold no assets but has a floating charge over assets over another entity (i.e. an entity with substantial assets, say Big Co). It may be appropriate in this case to consider that indirect recourse for payment is expected to be allowed against Big Co in this scenario. If Big Co was a foreign associate of Mid Trust, this would prevent the third party debt conditions from being satisfied where the borrower is able to increase its leverage via support from a foreign associate where a third party is interposed as the provider of the direct credit support (but where the support is in-substance being provided by a related party).

126. Either way, we believe it is important for the ATO to outline its view on the application of the indirect rule contained in subsection 820-427A(5).

Recourse to assets vs recourse against entities

127. We highlight that paragraph 820-427A(3)(c) and subparagraph 820-427A(5)(a)(i) refer to recourse for payment of the debt "to assets". By contrast, subparagraph 820-427A(5)(a)(ii) and paragraph 820-427A(5)(b) refer to recourse for payment of the debt "against an entity". The Draft Ruling addresses the concept of recourse in paragraphs 36 to 43. However, this appears to only cover the concept of recourse "to assets" (i.e. it states that the expression is used to delineate the pool of assets available in satisfaction or recovery of amounts owed).

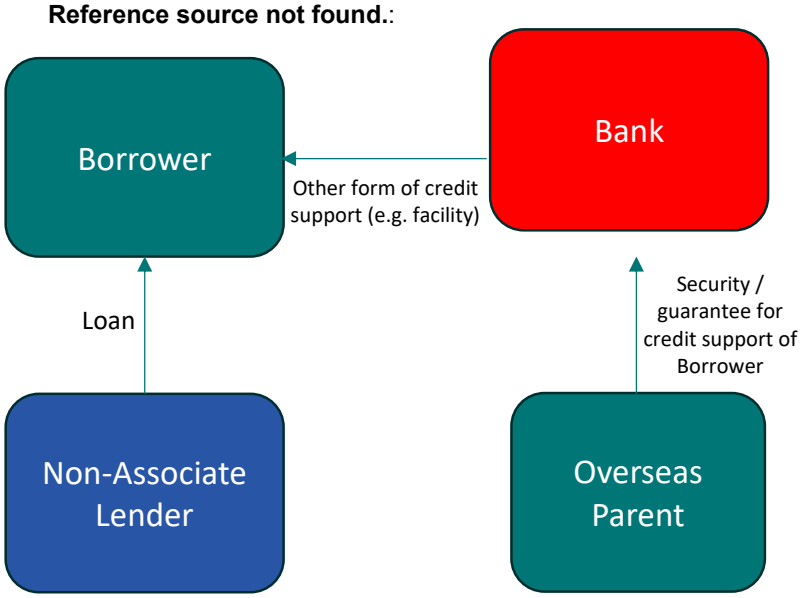
128. Paragraph 36 of the Draft Ruling should be updated to clarify that the relevant expression is only relevant for the two provisions which refer to recourse to assets. A separate interpretation is required when considering the expression 'recourse for payment of the debt' in the context of the two other provisions which refer to recourse against entities.

129. As the subject of those provisions is entities rather than assets, the expression cannot have the same meaning in that context. As the provisions do not mention assets at all, it cannot be that the expression is used to delineate a pool of assets. Rather it should be used to delineate the identity of any entities against which recourse is available.

130. In our view, recourse in this context should be taken to mean legal recourse (i.e. entities which may be sued in pursuit of recovery of the debt owed). It should not be taken to mean an entity whose assets may ultimately provide economic support for the payment of the debt.

131. This should cover rights held directly under a guarantee, security or other form of credit support to the provider of the relevant guarantee, security or credit support. However, if it cannot be expected that any legal rights to sue an entity will ever become available to sue an entity beyond the direct provider of a credit support right, then it should not be concluded that indirect recourse is available against that entity. This is consistent with our comments above in relation to Bank and Head Co in examples 17 and 18 of the Draft Ruling.

132. We refer back to Example 2 of this submission contained at paragraph 42 **Error! Reference source not found.**:



133. There are additional facts added, being that the Borrower's parent entity, being a foreign associate of Borrower is required to provide backing for the credit support provided by the Bank to the Borrower. This could be in the form of funds held on deposit, a security over its assets being granted to the Bank or a guarantee given to the Bank by the Overseas Parent.

134. These additional facts may lead one to conclude that the Non-Associate Lender's recourse to the credit support rights held by the Borrower may reasonably be expected to result in the exercise of those rights providing indirect recourse to the assets held by a foreign associate entity of the Borrower. The credit support rights allow the Borrower access to a bank facility to help repay the Non-Associate Lender. As this facility is only provided on the basis that the Overseas Parent has provided funds and/or security to the Bank, it may be concluded that the exercise of credit support rights provides indirect recourse to assets that are not Australian assets. As such, the exception in subparagraph 820-427A(5)(a)(i) should not be satisfied.

135. However, because subparagraph 820-427A(5)(a)(ii) considers recourse against entities rather than recourse to assets, it is arguable that a similar conclusion may not be reached. That is, it may not be reasonably be expected that the credit support rights held by the Borrower would permit it to have recourse, indirectly, against the Overseas Parent. It may be simply that the Borrower is expected to have recourse against the Bank only (i.e. if it had to enforce its rights, it would sue the Bank). It would then be a reasonable expectation that the Bank would simply fulfill its contractual obligations and provide the funds under the credit support facility to enable the Borrower to repay the Non-Associate Lender. While the Bank may be expected to pursue the Overseas Parent should the Borrower default under the credit support facility, this separate risk taken on by the Bank does not mean one would expect that the Borrower's exercise of its rights against the Bank would indirectly allow the Borrower (i.e. the holder of the credit support right) to ever have legal recourse against the Overseas Parent. It would be unreasonable to expect the Borrower to take control or ownership of the Bank's legal rights against the Overseas Parent in order to obtain funds under the credit support facility.

136. If the Borrower's recourse is not expected to be exercisable against any entity other than the Bank, the consequence is that both subparagraph 820-427A(5)(a)(ii) and paragraph 820-427A(5)(b) are satisfied, so that the debt interest may be able to satisfy the third party debt conditions (assuming other requirements such as the use of funds are satisfied).

137. We think it is critical that the Ruling address Example 2 of this submission from this perspective. While we understand the ATO may not necessarily agree with the view we have espoused, many inbound taxpayers are exploring how they are able to debt fund their Australian projects and rely on the TPDT to be able to deduct all their debt deductions in circumstances where the lender to be able to secure the loan beyond charges over the borrower's assets. This may involve another lender stepping in the place of the overseas related party and taking on that risk themselves. From the first lender's perspective, they obtain that extra security because another financial institution has agreed to take on some of the credit risk. While that other financial institution then separately manages that credit risk, this is under a separate agreement that does not involve the original lender. Taxpayers may consider that the TPDT is satisfied under arrangements of this kind, and it is important that this be addressed in the final Ruling.

138. We think this scenario would provide valuable guidance currently missing about the difference between direct recourse to assets of an entity as compared to recourse only to credit support rights held by an entity and then the subsequent consideration of the concepts of indirect recourse, both 'to assets' and 'against an entity'.

APPENDIX B – DETAILED COMMENTS ON THE DRAFT PCG (SCHEDULES 3 AND 4)

SCHEDULE 3 – Third party debt test compliance approach

Transitional compliance approaches

139. We highlight the compliance approaches referred to in paragraph 219 of the Draft PCG and make the following comments.

140. Paragraph 225 of the Draft PCG states that this compliance approach (about restructures to remove recourse to assets that are not Australian assets) applies to restructures undertaken before the end of the income year in which the Guideline is finalised. We are concerned that if the PCG is finalised close to the end of the 30 June 2025 income year that taxpayers will not have sufficient time to digest the final guidance, seek appropriate advice and implement the necessary restructure. Therefore, we suggest that unless the PCG cannot be finalised before 1 May 2025 that its finalisation be deferred to at least 1 July 2025 so that appropriate time can be available to appropriately implement restructures.

141. Alternatively, the compliance approach may be made available in respect of restructures implemented within a fixed time (e.g. 6 months) after the date the Guideline is finalised, rather than adopting an approach that gives different taxpayers a different time based on the accounting period they adopt.

142. We note that many taxpayers may be reluctant to rely on a Draft PCG that has not yet finalised (i.e. in terms of engaging with a third party financier to change terms of an agreement). Such modifications to agreements can result in refinancing and other costs. Furthermore, the ATO may change its mind in relation to certain safe harbours, or may change its mind with respect to the operation of the provisions in the final Ruling. Accordingly, taxpayers should be given an opportunity to act on the final PCG and thus must be given appropriate time after finalisation to implement any of the restructures covered by the compliance approaches.

143. We reiterate the above points in respect of the compliance approach set out at paragraph 251 of the Draft PCG (about restructures to comply with the same terms requirement in the conduit financing conditions), which is also stated to apply to restructures entered into before the end of the income year in which the PCG is finalised.

144. We also make some further comments about this compliance approach. Paragraph 251 of the Draft PCG states that the compliance approach is both retrospective and prospective (but only for income years ending on or before 1 January 2027). It is not immediately clear why a prospective compliance approach is required. If the restructure results in compliance with paragraph 820-427C(1)(d) in accordance with the ATO view, then it is not clear why a 'compliance approach' is required at all, particularly one that is said to expire. The expiration of the compliance approach may suggest that beyond 1 January 2027 that the arrangement will no longer satisfy the conduit financing conditions. We request that the purpose of these features of the compliance approach be clarified.

145. Under paragraph 243 of the Draft PCG, the compliance approach in relation to minor or insignificant assets states that it applies to certain income years. It is said to apply on retrospectively to periods before the relevant restructure is undertaken. It is not immediately evident what kind of restructures are envisaged for this compliance

approach. We note that paragraph 219 of the Draft PCG does not refer to this compliance approach as relating to a restructure at all, as it does for the other two compliance approaches.

146. The use of the term 'restructure' is therefore somewhat confusing. Example 23 of the Draft PCG does not involve a restructure at all. Rather, the compliance approach seems to merely be one that applies in respect of the ATO's intended application of the 'minor or insignificant assets' requirement. That is, taxpayers who do not restructure their affairs in anyway should nevertheless be able to rely on this compliance approach. For example, the taxpayer's borrowing provide the lender recourse to foreign assets in a way that satisfied the criteria in paragraph 245, and the taxpayer does not intend to rely on the TPDT beyond 1 January 2027. The taxpayer should be able to rely on the compliance approach without undertaking any kind of restructure. We therefore suggest that paragraph 243 be removed from the Draft PCG.

147. Lastly, we make an additional comment regarding paragraph 265 of the Draft PCG which states that Fin Co and Asset Trust do not recognise any gain or loss for tax purposes when closing out the swap. We are unclear whether this is a requirement in order to access the compliance approach (i.e. that the swap is closed out in a way that results no gain or loss was actually made by either party) or if this means taxpayers are allowed to disregard the ordinary operation of the income tax rules in relation to gains or losses actually made on closing out the swap. The PCG should clarify this.

Guidance on the conduit financing conditions

148. We note that paragraph 7 of the Draft Ruling states that the conduit financing rules are outside the scope of the Ruling. However, given that examples 24 to 26 in Schedule 3 of the Draft PCG explicitly reaches a conclusion (without explanation) about the application of the provisions we believe the Ruling should address these rules to some extent.

149. In particular, the 'same terms' requirement in paragraph 820-427C(1)(d) is the most critical provision that taxpayers require guidance on.

150. Example 24 of the Draft PCG implies that no mark-up is allowed in order to satisfy the condition as only the removal of the margin entirely would result in the back-to-back loan satisfying the third party debt conditions. We believe this is a critical area for guidance. In particular, the Ruling should clarify whether the ATO's view is that no mark-up whatsoever is permitted under this condition of the conduit financing rules (e.g. not even 1 basis point). While we expect some form of mark-up to be allowed to allow the conduit financer to recover reasonable costs of administration, as permitted by paragraphs 820-427C(2)(b)-(c), it should be clarified whether this means that the conduit financier is required to be an entirely break-even entity that cannot make a profit (if all it does is act as a conduit financer). Many such entities would expect to make a profit from its activities so that it can be said that it is carrying on a money lending business (i.e. one needs a prospect of profit to be considered a business) and to the nexus requirement in section 8-1 or section 230-15 is satisfied to ensure deductibility of its own costs.

151. Example 26 of the Draft PCG suggests that a loan by a conduit financer can be priced in a way that passes on the conduit's swap costs to the ultimate borrower. This should be address in the Ruling It may be simply that example 26 of the Draft PCG is a simple application of subparagraph 820-427C(2)(d)(ii) which allows the conduit financer to disregard terms that pass on its own hedging costs in respect of the debt interest.

152. Example 25 illustrates that loans sourced from multiple external lenders cannot be combined into a single loan to an associate entity. The Ruling should clarify this and also confirm that:

    152.1. Even multiple loans are obtained from the same external lender, if each loan is a separate debt interest, they must also be on-lent via separate intercompany loan agreements and not able to be combined into one; and

    152.2. One ultimate loan from an external lender can be used to make multiple smaller loans to multiple associates and that the conduit can use some of the borrowed funds for purposes other than on-lending (e.g. to fund its own administrative costs).

153. See also our comments below regarding Example 29 of the Draft PCG where we highlight the need for further clarity on the example (i.e. an explanation of how the restructure in the example satisfies the conduit financing conditions).

154. Lastly, we highlight that the view recently expressed in Draft TD 2024/D3 and Taxpayer Alert TA 2024/2 about the application of section 109U of the *Income Tax Assessment Act 1936* ("**ITAA 1936**") may have a significant impact on taxpayers in private groups seeking to access the conduit financing rules in the TPDT. Arrangements that conform to the requirements in section 820-427C may fall foul of section 109U as per the current view as Draft TD 2024/D3 does not provide any safe harbour for taxpayers who have entered into commercial arrangements in conformity with the requirements under the new thin capitalisation rules. We have made a submission in response to Draft TD 2024/D3 urging the ATO to provide a safe harbour to this effect. We strongly urge the different business lines of the ATO responsible for these public advice and guidance products to liaise with each other on this issue so that taxpayer subject to Division 7A are not unfairly impacted by the requirements contained in the new thin capitalisation rules.

SCHEDULE 4 – Restructures in response to the thin capitalisation changes

155. We make some observations about the examples provided in Schedule 4 of the Draft PCG.

156. We do not believe example 27 provides any meaningful guidance as the mere choice to consolidate an existing consolidatable group cannot be a scheme to which Part IVA applies.[21] This is noted at paragraph 275 of the Draft PCG which states that there is no actual restructure. This is inconsistent with purpose of the Draft PCG which is said to provide guidance in respect of restructures.

157. The example may be more meaningful if an additional step was included in the arrangement. That is, there is an actual restructure that places the group in a position to be consolidatable. This could be if Aus Co was interposed above Sub 1 Co and Sub 2 Co (e.g. beneath a trust) to enable the group to form tax consolidated group. Alternatively, a better example may be whereby the net interest costs throughout the group are reallocated. For example, this could be if Sub 1 Co pays a dividend to Aus Co, which is then on-lent to Sub 2 Co on interest-free terms to enable Sub Co 2 to pay down debt or lend the amounts out to generate interest income (thereby reducing its net debt deductions). A further alternative could be one in which Sub 1 Co had lent across to Sub 2 Co but then amends this agreement to reduce the interest rate or

[21] Refer to subsection 177C(2) of ITAA 1936.

switch off interest entirely in a way that results in both entities have their FRT limits not exceeding their net debt deductions for the year.

158. Example 28 also appears not to provide practical guidance for taxpayers as the borrowing from Finance Corp to fund a buy-back of shares appears to be a transaction that is clearly subject to the debt deduction creation rules ("**DDCR**") (as alluded to in paragraph 285 of the Draft PCG). As the DDCR is set to apply in the first instance, there is likely no room for Part IVA to apply. Further, the example should clarify whether Aus Co (under the previous thin capitulation rules) had adjusted average debt in excess of its maximum allowable debt (e.g. under the former safe harbour). If it were the case that Aus Co had excess gearing capacity (e.g. its adjusted average debt was well below 60% of its assets) then Aus Co would have likewise had an incentive to take on excess debt in order to borrow up to the safe harbour limits. If Aus Co did not undertake this transaction period to 1 July 2023, then it would be difficult to conclude (as is stated in paragraph 282 of the Draft PCG), that the restructure was done in response to the current rules if the same possibility existed under the former rules.

159. It is not clear to us how the restructure outline in example 29 achieves the supposed goal of maximising debt deductions as it appears that amending the term of the internal loans in the manner suggested would not comply with the conduit financing conditions in section 820-427C. The facts suggest that the entire quantum of the external loans is on-lent to Dev Co and Ops Co. If total amounts sourced from external lenders (say $100 million) was on-lent to Dev Co and Ops Co (say $50 million each), choosing the highest interest rate of all the external loans as the new interest rate for the internal loans would not comply with the same terms requirement the conduit financing rules. For the external loans that had a lower interest rate, the debt interests by which those amounts are on-lent would fail the requirements. Accordingly, we are unclear how example 29 demonstrates that the conditions in section 820-427A would be satisfied in order to be a high-risk case (i.e. it is simply an arrangement that does not qualify),

160. While the example could be such that one of the intercompany loans does not need to satisfy the third party debt conditions (i.e. the one the does not satisfy the same terms requirement), as all entities are part of the same obligor group, and therefore all deemed to apply the TPDT, presumably the restructure is intended to allow all entities to deduct their debt deductions in full pursuant to the TPDT.

161. We suggest that the example be changed so that it is one in which Fin Co has some other use of borrowed funds other than on-lending the amounts in full. For example, Fin Co may use some external funds for its own investment purposes, say $50m, with $50m on-lent. If the facts were thus, then the restructure could be one that is done in a way that the terms of the intercompany loans are amended so that the internal loans which charge the highest interest are the ones that are on-lent, say the $50m of external loans that charge the highest interest rates, with the lowest interest rate internal loans used to fund Fin Co's other activities.

162. However, we question the conclusion in Example 29 under any version of the key facts. Any arrangement that maximises debt deductions for Dev Co or Op Co necessarily increases assessable interest income derived by Fin Co. If this is the broad outcome of the arrangement, without anything further (e.g. facts such as Fin Co having a large pool of tax losses), we do not believe it is credible that there is a dominant tax purpose where the arrangement merely results in one group subsidiary increasing its deductions and another subsidiary increasing its assessable income by an equivalent amount. A section 177F compensating adjustment may be appropriate in such circumstances, which would effectively neutralise the effect of any Part IVA determination.

163. Lastly, we highlight that merely amending terms of internal agreements would not appear to necessarily satisfy the conduit financing rules. Merely adjusting interest rates and maturity dates of the intercompany loan does not alter requirement in paragraph 820-427C(1)(c) that the amount on-lent be financed by the conduit financer only with the proceeds of the particular external loan. If the facts were such that funds from the external loans were intermingled, then this requirement may not be satisfied (e.g. $1 million from External Loan 1 and $1 million from External Loan 2 were used to finance a $2 million loan to Dev Co). We highlight this same issue arises in Example 25 of the Draft PCG. Merely amending related-party legal agreements does not necessarily establish that only the proceeds of Ultimate Loan 1 were actually used to finance Intercompany Loan 1, and so on. We believe the Ruling should provide some guidance on this issue and perhaps a sensible compliance approach can be adopted to obviate the need to trace the use of every single dollar a conduit financer borrows and on-lends. The Draft PCG seems to a adopt a sensible practical approach. However, we believe the Draft PCG and/or Draft Ruling more directly address this issue and explain the ATO's compliance approach in respect of it.

APPENDIX C – DETAILED COMMENTS ON THE DRAFT PCG (SCHEDULES 1 AND 2)

164. There are aspect of the Schedules of the Draft PCG that provide an ATO view or explanation of how it considers certain aspect of the DDCR rules apply. That is, the Draft PCG goes beyond providing a mere practical guidance approach and makes statements that are more akin to those that would be expected in a public ruling. Example 1 of the Draft PCG is an example of this as it is more of an explanation of how to interpret the DDCR from a timing perspective rather than indicating what kinds of transactions are more likely to receive ATO scrutiny.

165. In the absence of a public ruling on the DDCR, we nevertheless believe that these part of the Draft PCG are helpful for taxpayers and advisers. In this Appendix we set out various discrete issues that we suggest could be addressed in a similar way in the final PCG. That is, the ATO could consider amending or adding examples to address the below aspects of the DDCR.

165.1. Acquisition of an obligation – Subsection 820-423(2) covers acquisitions of legal or equitable obligations. It should be clarified whether this covers the mere borrowing of money or is limited to the assumption of obligations (e.g. a debt defeasance arrangement). Further, it is difficult to conceive how debt deductions relate to such an acquisition or holding of an obligation. Normally one would expect that amounts borrowed to fund the purchase of assets result in debt deductions being incurred in relation to the acquisition. Where an entity assumes an obligation, it would usually do this to obtain something in return. That is, it would not need to borrow (and incur interest on the borrowing) to fund the acquisition of the obligation (as it would usually receive consideration for assuming an obligation, as outlined in the case of *Orica*[22]). It may be that the obligation assumed is the thing under which the debt deductions are incurred, but such a view may result in every related party borrowing being subject to the DDCR which appears to render the other requirements of the provisions redundant. It is important that some guidance is provided to clarify the kind of arrangement for which an acquisition of a "legal or equitable obligation" result in the application of the DDCR.

165.2. Facilitate the funding of a distribution – The words "facilitate the funding" of suggest that some lesser connection that using borrowed money to fund a distribution can result in the application of a Type 2 DDCR case. Given that entities, particularly trusts, make distributions on a regular basis, this gives rise to significant uncertainty due to the fungibility of money as to whether any of its borrowings can be said to facilitate the funding of a distribution even if borrowing can be identified as directly funding something else (e.g. the acquisition of a capital asset). It is critical that the ATO set out both low-risk and high-risk views as to its likely application of the DDCR. We believe low-risk scenarios should be those where the distribution and the borrowing are merely coincidental and high-risk scenarios are ones where there is an element of contrivance (e.g. using associate debt to fund an asset acquisition and using third party debt to fund a distribution as part of a plan or arrangement). Only in these latter cases should it be considered that the related party borrowings facilitate the funding of a distribution.

165.3. Scope of royalty – The definition of royalty in the Act includes both the use of industrial, commercial or scientific equipment (which excludes rent from an interest in land or fixtures) and the supply of scientific, technical, industrial or

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22 *FCT v Orica Ltd* [1998] HCA 33.

commercial knowledge or information.[23] An example in the PCG could highlight the risk of a service entity leasing property, plant and equipment to an associate and the potential application of subsection 820-423A(5) to the arrangement, at least to the component that does not relate to the lease of any premises (and fixtures thereon). Another example could include a management entity providing services that may be considered the supply of knowledge or information. Additionally, the PCG could explain what it considers to be a "similar payment" for the use of, or right to use, an asset.

165.4. Construction contract – It is common for property developer groups to have a developer entity to provide services to a landholding entity. This could involve both the provision of parts and labour. It should be clarified that this sort of agreement is not usually one that would be considered to result in the acquisition of assets from the developer. Even if the developer was not acting as an agent in respect of the parts or materials, we believe the better view is that the landowner is not acquiring assets from an entity (e.g. bricks, planks of wood, etc) but rather than these assets are being added to and merging with the land as they are being affixed to it, rather than the landowner being considered to acquire such assets in their own right, as standalone assets. This may not be the case for certain depreciating assets which may be considered separate assets in their own right, but the exclusion in section 820-423AA may be relevant for these.

165.5. Conversion of UPEs to Division 7A loans – It is a well-established practice that trusts making distributions of income to corporate beneficiaries are able to retain the funds if they borrow these on Division 7A terms. Refer to paragraph 105 of TD 2022/11 and paragraph 25 of PCG 2022/2 for example where the ATO facilitates and encourages some arrangements. Example 10 of the Draft PCG does not address the scenario of Gold Co being the beneficiary of the unpaid present entitlement and lending this back to Zinc Trust. Given the prevalence of such transactions, the PCG needs to address this. We suggest this example can be distinguished from Example 10 in a sensible way. It may be considered that in such cases, it is not the financial arrangement (i.e. Division 7A loan) that funds the distribution, but rather it is the distribution which funds the Division 7A loan. That is, the causality is the reverse of what subsection 820-423A(5) requires. Further, this is supported by the substance of the arrangement being that what is happening is that the trust is taking on a Division 7A loan to fund its commercial or investment activities. It would be artificial to say that the trust is using a financial arrangement to pay a distribution where the trust is the one that holds on to the funds. It is more accurate to say that the trust used the financial arrangement for the fund the thing it actually used the money for (e.g. to acquire an investment property).

165.6. Refinancing – Paragraph 820-423A(5A)(f) contains an express refinancing rule, but there is no equivalent for subsection 820-423A(2) asset acquisition type cases. This may be clarified with an example. For instance, an asset acquired from a related party was funded by related party debt, which is subsequently refinanced. It may be considered that the debt deduction incurred under the new loan still relate to the original acquisition (or otherwise the continual holding of the asset). This could also be the case in respect of the new debt where the original acquisition was funded in some other way (e.g. from retained earnings or third party debt). However, where the asset is no longer held, it should only be considered that any remaining debt that was obtained to fund its acquisition

[23] Subsection 6(1) of ITAA 1936.

still relates that acquisition in limited circumstances, such as those outlined in TR 2004/4 relating to trailing expenses following the authority in the decisions of *Brown* and *Jones*. Where the proceeds of the sale of the asset are not used to repay the debt, but are instead redeployed for some other purpose, the debt deductions that arise thereafter should be considered to relate to that use, rather than the original use.

165.7. Indirect transactions – Paragraphs 31 to 35 of the Draft PCG provide an overview of indirect Type 1 and Type 2 arrangements. The guidance notes that the nexus is deemed as a result of the 'sufficient if acquisitions/payments exist'. Firstly, we suggest that it be clarified that for the purposes of subsections 820-423A(6)-(7), indirect transactions of more than one payment or distribution requires each payment or distribution to be of the kind mentioned in subsection 820-423A(5A), rather than any kind of payment or distribution, terms which are otherwise undefined for the purposes of this provision. Secondly, the PCG must clarify that despite a deemed acquisition or deemed payment or distribution, the requirements in paragraph 820-423A(2)(d) for Type 1 cases and paragraph 820-423A(5)(e) for Type 2 cases is that the nexus requirement must nevertheless be considered between the debt deductions and the deemed transaction. That is, the deeming rules simply deem the arrangement to be an indirect acquisition or distribution, however, there still must be a coherent or commercial link between the related party borrowing and the ultimate related party acquisition or payment or distribution. We think this is particularly necessary to emphasise as any other view would make the rules unworkable as there is otherwise no time limitation in respect of deemed indirect transactions (i.e. if acquisition 1 occurred in 2000 and acquisition 2 occurred in 2030, the deeming rules states that there is an indirect acquisition merely because both exist). This can be contrasted with section 832-625 (which is the provision which originally used the concept of "sufficient if payments exist") as that provision contains a strict time limitation as it requires the Australian deduction and deduction component of the offshore hybrid mismatch to both occur within a common tax period.

165.8. Acquirer or payer is not the relevant entity – Paragraph 820-423A(2)(c) for Type 1 cases and paragraph 820-423A(5)(c) for Type 2 cases contemplate that the entity whose debt deductions are denied may not necessarily be the same entity that made the relevant acquisition or payment or distribution. The PCG should highlight this and provide a practical example. We understand that the International Dealings Schedule for 2025 will include a new question 58 requiring disclosure for these scenarios. The explanation to that question suggests this is to cover "associate entities on the other side of the relevant arrangement". We are not sure this is correct. Firstly, the DDCR applies to transactions involving associate pairs, not associate entities. Secondly, it is confusing to suggest these rules apply to the entity on the "other side of the relevant arrangement". This would indicate the vendor (for a Type 1 case) or the recipient (for a Type 2 case) somehow has deductions that relate to the their disposal of the asset or their receipt of the payment or distribution. This is difficult to conceive. This should be clarified in the PCG. We believe that it will be inappropriate to require taxpayers to complete this IDS question without the ATO providing an appropriate explanation or an example of the type of transaction that can fall within this question.

165.9. Entity not able to use a section 230-50 type financial arrangement to fund payments or distributions – The term financial arrangement includes situations where an entity has an equity interest under section 230-50. This was included

to accommodate TOFA treatment under particular elective methods in respect of equity interests. It would not seem appropriate for the DDCR to apply to such financial arrangements as it is difficult to see how the holder of an equity interest can be said to use it to make a payment or distribution in the same way that the borrower under a financial arrangement can be said to use the proceeds from the financial arrangement to make a payment or distribution.

165.10. Typo in paragraph 137 – We note the word “DDCR” was removed in the first sentence in this paragraph, which appears to be a mistake.