The Tax Institute

22 March 2024

Mr Stephen Dodshon
International Risk Manager
International Risk and Projects, Public Groups
Australian Taxation Office

By email: Stephen.Dodshon@ato.gov.au

Dear Mr Dodshon,

Amendments to the Thin capitalisation rules – ATO's Public Advice and Guidance Consultation

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in respect of its Public Advice and Guidance (**PAG**) consultation on the changes to the thin capitalisation rules.

In the development of this submission, we have closely consulted with our National Large Business & International Technical Committee and a working group of members with expertise in this area to prepare a considered response that represents the views of the broader membership of The Tax Institute.

The Tax Institute commends the ATO on its proactiveness in preparing PAG for the implementation of the new thin capitalisation rules.

We are of the view that guidance on a range of issues associated with the new rules is crucial in assisting taxpayers and their advisors in complying with their obligations. The provision of such guidance by the ATO will provide certainty to taxpayers and help ensure compliance with the intended effect of these fundamental changes to the Australian tax treatment of interest and equivalent costs.

By way of priority, The Tax Institute is of the view that comprehensive guidance needs to be issued as soon as practicable dealing with the:

- proposed debt deduction creation rule (**DDCR**), by way of a comprehensive law companion ruling (**LCR**) coupled with a practical compliance guide (**PCG**), including risk assessment frameworks;
- impact of the transfer pricing rules as to the quantum of debt, by way of a PCG, coupled with revisions to existing PCGs and/or the issue of a new PCG including risk assessment frameworks;

- Commissioner's intended approach towards, and management of, transitional and compliance issues arising from the rules, including its approach to the application of Part IVA to restructures etc, by way of a PCG, including risk assessment frameworks; and
- guidance to address ambiguity in the revised 'financial entity' definition.

Comprehensive guidance is also recommended in relation to the operation of the fixed ratio test (**FRT**), group ratio test (**GRT**), and third-party debt test (**TPDT**), as well as a range of specific issues.

Our detailed response and recommendations are contained in **Appendix A**.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact our Senior Counsel – Tax & Legal, Julie Abdalla, at (02) 8223 0058.

Yours faithfully,

Scott Treatt
Chief Executive Officer

Todd Want
President

APPENDIX A

We have set out below our detailed comments and recommendations for your consideration.

Priority issues based on broad application, compliance cost and risk involved

Based on their broad application, compliance cost, and level of risk, we have compiled a list of the priority PAG issues below.

Debt deduction creation rule

Detailed guidance on the way the ATO will apply the DDCR, including practical examples of common scenarios and guidance in respect of the following matters:

- Understanding the ATO's approach to tracing issues related to pre-existing financing arrangements and the historical use of the funds is crucial when it comes to the application of these rules.
- The application of the rules to purely domestic arrangements (i.e., where there is no net deduction reducing the Australian tax base).
- The application of the rules to transfers of trading stock, in particular for businesses with a high volume of such transactions (as noted by Treasury on page 7 of their submission to the Senate Economics Legislation Committee's inquiry into the Government Amendments to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill* 2023 (5 January 2024) (**Treasury Submission**).
- The application of the specific anti-avoidance rule to restructures undertaken to comply with the rules (see our general comments below).
- Guidance on the meaning of 'facilitate the funding of' in the second DDCR (see proposed subsection 820-423A(5) of the *Income Tax Assessment Act 1997* (Cth) (**1997 Act**)).

We recommend that a comprehensive LCR be produced to address the above issues, including examples.

Additionally, a guidance product, such as a PCG including risk assessment frameworks, would assist taxpayers in applying the rules by providing guidance addressing the above issues as appropriate and in particular, covering the following:

- types or examples of arrangements the Commissioner would consider high, medium and low risk – identifying for example, how the ATO would approach arrangements where there is no risk to revenue (e.g., borrower and lender are both Australian residents), or the dominant purpose of the arrangement is commercial;
- record-keeping requirements, including timing, that would be acceptable to the Commissioner, for example in relation to tracing of funds; and

- any application of transitional compliance rules by the ATO, which would help taxpayers to manage the retrospective application of the new rules to existing arrangements. Guidance similar to the approach in Practical Compliance Guide 2018/9: *Central management and control test of residency: identifying where a company's central management and control is located* **(PCG 2018/9)** (from [102]) would be most welcome in providing taxpayers and the ATO with certainty on these rules.

Transfer pricing and its interaction with thin capitalisation

The proposed amendment to section 815-140 of the 1997 Act means that for general class investors, the quantum of debt subject to the thin capitalisation rules will first need to be subject to the arm's length condition in the transfer pricing rules. Taxpayers would benefit from guidance regarding the determination of appropriate debt quantum.

This could potentially involve the introduction of a new risk assessment framework for an updated version of Practical Compliance Guideline 2017/4: *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions* (**PCG 2017/4**).

Furthermore, having regard to the compliance burden that may be placed on smaller taxpayers, particularly in relation to documenting transfer pricing positions, recognition of a simplified approach that the ATO would accept in documenting and/or complying with the transfer pricing rules is recommended (e.g. something along the lines of Practical Compliance Guideline 2017/2: *Simplified transfer pricing record-keeping options* **(PCG 2017/2)** would be welcome).

The proposed amendment to section 815-140 of the 1997 Act is likely to impact a significant number of larger taxpayers who will need to allocate additional compliance resources to address the issue of whether the principal amount of the debt instruments issued by them are consistent with arm's length conditions, in addition to determining if the interest rate associated with such debt instruments is consistent with arm's length conditions.

Further, anecdotal evidence suggests that some smaller taxpayers may not have been correctly applying section 815-140 of the 1997 Act. This is on the basis of a view being taken that section 815-140 of the 1997 Act enables an entity to gear up to the safe harbour limits in the thin capitalisation rules, notwithstanding that the thin capitalisation rules do not strictly apply to the taxpayer, for example, because the total of the taxpayer's debt deductions in an income year are below the $2 million threshold in section 820-35 of the 1997 Act.

There is an absence of ATO interpretative guidance in relation to how to determine if the principal amount of the debt instruments issued by taxpayers are consistent with arm's length conditions for the purposes of Subdivision 815-B of the 1997 Act. Neither TR 2014/6: Income tax: *transfer pricing – the application of section 815-130 of the ITAA 1997*[1] (**TR 2014/6**), nor TR 2014/8: Income tax: *transfer pricing documentation and Subdivision 284-E*[2] (**TR 2014/8**), provide such guidance. This can be contrasted with the situation under the thin capitalisation rules where the ATO has issued detailed guidance with respect to the arm's length debt test, originally in TR 2003/1 and more recently in TR 2020/4 and PCG 2020/7.

Having regard to the above, we recommend that the ATO:

- issue a taxation ruling to address the above issues, including providing examples;
- amend TR 2014/6 to address the application of section 815-130 of the 1997 Act in relation to debt instruments issued by a taxpayer, for the purposes of identifying arm's length conditions; and
- amend TR 2014/8 to address the records that a taxpayer should keep for the purposes of having a documented transfer pricing position under Subdivision 284-E of Schedule 1 to the *Taxation Administration Act 1953* in relation to debt instruments issued by a taxpayer, for the purposes of identifying arm's length conditions.

Similarly, there is an absence of practical compliance guidance issued by the ATO to assist taxpayers in understanding if the ATO is likely to allocate compliance resources in relation to the principal amount of the debt instruments issued by them for the purposes of the transfer pricing rules in Subdivision 815-B of the 1997 Act. In this respect, neither PCG 2017/2: *Simplified transfer pricing record-keeping options* (**PCG 2017/2**) nor PCG 2017/4: *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions* (**PCG 2017/4**) provide such guidance as they only address the related issue of whether the interest rate associated with such debt instruments is likely to be consistent with arm's length conditions.

Additionally, we recommend that the ATO issue further and more comprehensive practical compliance guidance in relation to whether the principal amount of debt instruments issued by taxpayers are likely to be consistent with arm's length conditions. This could potentially include:

- the introduction of a new risk assessment framework for an updated version of PCG 2017/4, or alternatively, the introduction of a new risk assessment framework in relation to the principal amounts of debt instruments issued by an entity; and
- confirmation that taxpayers can continue to rely on the Low-level inbound loans simplified transfer pricing record-keeping option in PCG 2017/2, or alternatively, the introduction of a new simplified transfer pricing record-keeping option in relation to the principal amounts of debt instruments issued by an entity.

[1] Paragraphs 65-76.

[2] Paragraphs 58-60.

Transitional compliance, including Pt IVA

The new thin capitalisation rules represent a dramatic shift in law for taxpayers and many will need to restructure their arrangements to comply with the changes, particularly given their retrospective nature due to a lack of grandfathering.

We recommend that the Commissioner outline a compliance approach in respect of restructuring by taxpayers to comply with the new rules (as was suggested on page 8 of the Treasury Submission).

This guidance should cover both Pt IVA and the new anti-avoidance rule in the DDCR. Such an approach should be similar to that taken in relation to the hybrid mismatch rules as set out in Practical Compliance Guideline 2018/7: *Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements* (**PCG 2018/7**).

Financial entity definition

The revised definition of 'financial entity' in subsection 995-1(1) of the 1997 Act is unclear and is creating a lot of issues for taxpayers who need to determine which thin capitalisation rules apply to them. To provide certainty to taxpayers, we recommend the Commissioner provide guidance confirming the activities the Commissioner would consider are 'predominantly directly or indirectly to or on behalf of their associates' (i.e., is the 'on behalf of' a reference to an agency relationship as opposed to something more remote?). The guidance should confirm that merely borrowing from an associate entity and on-lending to the third-party borrower would be acceptable. The new test refers to 'profits' so it should be confirmed that an entity can still be a financial entity where it does not have profits at a particular time (i.e., it is in a loss position).

We consider that an LCR or Tax Determination would be an appropriate product to address this issue.

Other issues, including preferred form of guidance

Based on feedback received from our members, The Tax Institute is of the view that an ideal form of guidance would be a comprehensive manual specifically designed for the new interest limitation rules, similar to the consolidation reference manual.

Further, the table below identifies areas/uncertainties within the new thin capitalisation rules that we consider would benefit from specific and/or further guidance and the recommended ATO product.

	Issue	Description	Recommended ATO product
General/definitional issues			
(1)	**'Economically equivalent to interest' and concept of debt deduction and net debt deduction**	The amended definition of debt deduction is critical to determine the extent to which the new rules will impact tax deductibility. In addition, the concept of net debt deduction is a new concept that also looks at only certain amounts that would be assessable (subsection 820-50(3)). We recommend that the Commissioner provide examples of what would and would not be covered by the concept of 'amounts economically equivalent to interest'. For example, would calculations that merely take into account the time value of money (e.g., CPI increases in commercial rental agreements), swaps (also see later) or which flow through partnerships or trusts be covered?	LCR
FRT and GRT			
(2)	**Fixed ratio test and group ratio test**	Examples of the application of the rules, including excess tax EBITDA capacity sharing, in common scenarios such as groups of property trusts and staples. It is also unclear how the group ratio or excess tax EBITDA will apply to entities with a different income year (e.g. other members of the GR group because of the reference to the 'period corresponding to the income year' in subsection 820-46(3)). This is particularly important due to the current lack of guidance in the explanatory materials.	LCR

	Issue	Description	Recommended ATO product
TPDT			
(3)	**TPDT**	Examples of the application of the rules to common financing arrangements and how the third-party debt conditions and the conduit financier rules apply to those arrangements. Examples that would be useful include: • how the rules would apply to Australian parented MNEs (with indirect or direct interests in offshore subsidiaries); • how taxpayers may keep records that would be acceptable to the ATO to prove the use of funds; and • how back-to-back swaps (including portfolio swaps) should be treated (see also below).	LCR
(4)	**Swaps**	Clarification is required about what 'directly associated' means in the TPDT (see paragraphs 820-427A(2)(a); and 820-427C(2)(d) and (e)(ii)), and what the Commissioner would accept as supporting the requisite connection. More broadly, examples of the treatment of different varieties of swap arrangements, not only under the TPDT, but for the purposes of applying the net debt deduction concept), would provide certainty to taxpayers.	LCR
(5)	**'Minor or insignificant', 'Australian asset', and 'substantially all'**	Clarification of the meaning of 'minor or insignificant' and 'Australian asset' in relation to the third-party debt conditions (see paragraph 820-427A(3)(c) and subsection 820-427A(4)) and 'substantially all' (paragraph 820-427A(3)(d)). We recommend quantifiable benchmarks of 10% for 'minor or insignificant' and 90% for 'substantially all' as appropriate.	LCR (and potentially a PCG to the extent that 'safe harbour' guidance is provided)