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Stephen Dodshon
Assistant Commissioner
New Measures, Public Groups
Australian Taxation Office

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Dear Mr Dodshon,

Thin capitalisation rules – the third party debt test: Draft Taxation ruling TR 2024/D3 and updated Draft Practical Compliance Guideline PCG 2024/D3

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 175,000 members in over 100 countries and regions. We make this submission in response to the Australian Taxation Office (ATO)'s draft **TR 2024/D3 Income tax: aspects of the third party debt test in Subdivision 820-EAB of the Income Tax Assessment Act 1997** (Ruling) and updated draft **PCG 2024/D3 - Restructures and the new thin capitalisation and debt deduction creation rules - ATO compliance approach** (PCG) released on 4 December 2024 on behalf of our members.

While we acknowledge the complexity of the thin capitalisation reforms, we are concerned that the ATO's approach to the third-party debt test (TPDT) is unduly restrictive and imposes impractical compliance burdens on taxpayers. The changes to the thin capitalisation regime will require taxpayers to restructure ordinary business financing arrangements, yet demonstrating eligibility for the TPDT to the satisfaction of the ATO will be challenging without significant forward planning.

The ATO appears to adopt a policy stance that the TPDT is only intended for a narrow class of taxpayers - primarily those in the property and infrastructure sectors. This interpretation significantly limits access to the TPDT, despite the legislation itself not expressly imposing such constraints. Even where a taxpayer's circumstances should allow them to qualify for the TPDT, the evidentiary burden imposed by the ATO makes it practically unworkable unless significant pre-planning measures were taken.

For many businesses, particularly those with high gearing levels, access to the TPDT may only become relevant when earnings decline or interest costs increase - circumstances that cannot always be anticipated. However, at that stage, they may be unable to meet the stringent criteria set out by the ATO, as they would not have taken preparatory steps that were previously unnecessary under the fixed ratio test. If Parliament had intended to limit access to the TPDT to specific sectors, this could have been achieved in a more transparent and targeted manner rather than through overly restrictive administrative interpretations.

In addition to concerns regarding general accessibility, we wish to highlight several key issues:

- **Definition of "minor or insignificant" assets:** The ATO's narrow interpretation of this term, equating it to "minimal or nominal value," is overly restrictive. The phrase should instead be assessed relative to the taxpayer's total asset base rather than as an absolute measure.
- **Australian assets:** The Ruling's approach to determining whether an asset is "Australian" is unduly complex and appears to go beyond the legislative intent. The ATO's requirement that an asset be

"exclusively" Australian is not supported by the legislation and creates significant uncertainty, particularly in relation to shares in Australian companies with foreign permanent establishments.

- **Capital management and commercial activities:** The Ruling's treatment of capital management activities is overly rigid. The ATO's view that capital management (including borrowing costs and distributions) does not constitute a commercial activity fails to recognise the reality of business financing and investment structures. If a borrowing is commercially driven and entered into on an arm's length basis, it should qualify under the TPDT.

- **Transitional:** The ATO includes compliance approaches available for restructures undertaken before "the end of the income year in which the Guideline is finalised". The ATO should then not finalise the Ruling and PCG until July 2025, so as to allow taxpayers time to consider and forward plan their operations in light of the TPDT.

CPA Australia urges the ATO to reconsider these positions to ensure the TPDT is a viable and practical option for businesses with genuine third party debt. We encourage a more flexible and pragmatic approach that reflects commercial realities and aligns with the legislative intent.

Please refer to the Appendix for our detailed discussions. If you have any queries, contact me at jenny.wong@cpaaustralia.com.au or Bill Leung, Tax Technical Advisor at bill.leung@cpaaustralia.com.au.

Yours sincerely,

Jenny Wong
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Appendix

Detailed discussion

Specific comments

TR 2024/D3

Clarification of recourse and credit support right concepts

Example 6 gives an example of a “third party guarantee” as a credit support right for which the exceptions in s 820-427A(5) are then considered in Example 18.

However, Example 6 is a case where the taxpayer (i.e. borrower Mid Trust) is not the entity whose obligations are guaranteed. Rather, the tenant/lessee (Sub Co) is the entity whose obligations are guaranteed, which is said to give rise to a right (i.e. a credit support right) held by the taxpayer.

The more common case of a guarantee is one whereby the taxpayer/borrower (in this case Mid Trust) obtains a guarantee from a related entity. In this case, the Ruling should clearly explain that this does not mean the borrower hold an asset that is a credit support right (e.g. it is the lender/Bank that will hold the rights under the guarantee). Therefore, the exception in s 820-427A(5) is not relevant in this particular scenario.

Where the borrower has its obligations guaranteed, the guarantors will be obligors under s 820-49 and it needs to be the case that the guarantors are Australian entities who only provide recourse over Australian assets.

An additional consequence is that the obligor entities will be deemed to make a choice to apply the TPDT under s 820-46(5).

In summary, where the borrower’s obligations are guaranteed you should be looking to subsection 820-427A(4) (as the credit support right is not attributed to the borrower but the lender) and where the borrower’s rights/receivables are supported by guarantees then you should be looking to subsection 820-427A(5). We think this distinction should be properly explained in the Ruling.

Minor or insignificant – section 820-427A(3)(c)

The phrase "minor or insignificant” relates to paragraph 820-427A(3)(c) of ITAA 97, which stipulates that when determining the assets to which a debt interest holder has recourse, one should disregard recourse to assets that are "minor or insignificant".

Limiting the phrase "minor or insignificant assets" to assets of minimal or nominal value unduly narrows the statutory text. The statutory construction must begin with the text itself, considering the language used in light of its context and purpose[1].

The term "minor" or “insignificant” is not defined in the legislation and should therefore be interpreted according to its ordinary meaning. Based on the Oxford English Dictionary, "minor" is defined as "relatively small or ...unimportant; not regarded as being among the most notable of a specified group of persons or things". This suggests the term "minor" is a relational term, requiring comparison to something else. “Insignificant” is defined in the Oxford English Dictionary as “devoid of significance, weight or force. Of no importance … immaterial, trivial, trifling”.

Under the TOFA provisions, the definition of ‘financial arrangement’ in section 230-45 references ‘insignificant’ in a relative sense:

(f) *the one or more rights and/or obligations covered by paragraph (c) are not insignificant in comparison with the right, obligation or combination covered by paragraph (a), (b) or (c).*

The ordinary meaning of “insignificant” imports a concept of relative importance and so would vary according to the entity and circumstances (e.g., $1 million may be insignificant for one taxpayer, but significant for another). In that

[1] intepretation NOW!: 28 February 2017 | Legal database

sense, it is similar to “material/immaterial” but we would accept that it is further along the spectrum (i.e., an insignificant amount is less than an immaterial amount)

In addition, the existence of “or” in “minor or insignificant” means that the two terms are meant to be differentiated and not to be read is a composite expression.[2]

In a relative sense, the appropriate comparator in the context of s 820-427A(3)(c) of “minor or significant assets” is the Australian asset base to which the debt interest holder has recourse. A foreign asset would be considered minor if it is relatively small compared to the Australian asset base and has no impact on the debt's amount or terms.

The EM at paragraph 2.90 states “*The third party debt test operates effectively as a credit assessment test, in which an independent commercial lender determines the level and structure of debt finance it is prepared to provide an entity*.”

This interpretive approach would seem to better reflects the policy intent of the TPDT as a credit assessment test and avoids contravening s 820-427A(3)(c) for "inadvertent and superficial reasons".

We therefore disagree with the ATO's stance in Example 9 of TR 2024/D3, where assets constituting 2% of the Aus Hold Co group's total assets were deemed not to be minor or insignificant “because they are not of minimal or nominal value”.

In Example 10 of TR 2024/D3, the ATO view is that the fact that recourse to the foreign assets did not (or would not) impact the amount or terms of the debt "is not determinative" of whether they are "minor or insignificant". This statement could be clarified by the ATO to accept that this is a relevant consideration (even if not viewed by the ATO as determinative).

Definition of Australian asset

Paragraph 82 of TR 2024/D3 states that the physical location of the asset is generally determinative. The ATO should provide guidance to cover situations where the asset is in transit and temporarily located outside Australia.

The ATO’s position in paragraph 83 suggests that an asset cannot be considered an “Australian asset” if it has more than a "tenuous or remote" connection to a foreign jurisdiction.

In Example 13, shares in an entity with a foreign permanent establishment (PE) are not treated as Australian assets. The ATO considers the existence of a PE as more than a "tenuous or remote" connection to a foreign jurisdiction.

We disagree with the ATO’s approach of looking through shares in an Australian company to assess the company’s underlying activities. The presence of an overseas PE - regardless of whether it represents a minority of the company's activities - should not automatically disqualify shares from being Australian assets. There is no legislative basis for the ATO’s position that an asset must be effectively "exclusively" Australian to qualify. Paragraph 42 of the draft Ruling states that a no-look-through approach should apply, and the ATO should follow this principle.

This issue may arise due to the absence of an exclusion in s 820-427A(4)(a), unlike in s 820-427A(4)(b), which specifically requires looking through a membership interest. If this is a drafting oversight, it would be preferable for Treasury to address it rather than for the ATO to take an overly restrictive interpretative approach.

There is no clear basis for the ATO adopting "tenuous or remote" as a threshold test.

The ATO’s approach seems particularly unfair where the asset is a minority interest or a passive investment in an Australian company. Shares in an Australian company should be considered Australian assets without requiring an assessment of the company’s underlying assets and activities.

If the ATO’s general approach is to be accepted, the term "tenuous or remote" is inconsistent with language used in other provisions, particularly the exception for "minor or insignificant assets." Under the ATO’s interpretation, even if a PE consists of "minor or insignificant assets," shares in the entity would still not be Australian assets

[2] intepretation NOW!: 28 February 2017 | Legal database

solely because the PE's existence means the connection with the foreign jurisdiction is not "tenuous or remote".

In Example 14 at paragraph 94, the ATO treats shares in a controlled foreign company (CFC) as not being Australian assets. It seems like a harsh outcome if income of the CFC is attributable.

Use of proceeds – s820-427A(3)(d)

At paragraph 99 of TR 2024/D3, the ATO's view that the "use" of debt proceeds is an ongoing test requiring taxpayers to continuously monitor how funds are used over time is impractical. Under this approach, if debt is used to acquire an asset that is later sold, taxpayers must track how the sale proceeds are subsequently deployed. This requirement is unworkable in practice. Taxpayers with even moderately complex operations will struggle to trace the use of funds in this manner. In principle, a deduction should not be denied where a company maintains its Australian tax base.

For example:

- A company borrows to acquire an Australian asset (market value $100).
- The company generates income and acquires another Australian asset (market value $100).
- It then sells the original asset and reinvests in a foreign asset (market value $100).
- The loan remains secured by the company's Australian assets, which have consistently been maintained at $100—matching the debt amount. Given that the company's Australian asset base remains unchanged, there is no clear basis for denying a deduction.

If the ATO is concerned about potential manipulation of the use of funds, other safeguards already exist within the provisions to prevent abuse, including:

- **Recourse to Australian assets** – Lenders typically align recourse with company assets. Where recourse is limited to Australian assets, lenders may impose covenants to maintain the Australian asset base or expand their recourse rights. In the former case, no tax mischief arises. In the latter case, the situation is already addressed under s 820-427A(3)(c), which requires recourse to remain limited to Australian assets.

- **Anti-avoidance rules** – Existing anti-avoidance provisions further mitigate risks of misuse.

All, or substantially all

At paragraph 102 of TR 2024/D3, the ATO interprets "all, or substantially all" as meaning "all except for a minimal or nominal amount." This narrow interpretation unduly limits the scope of a potential exception.

We submit that "substantially all" should allow for more than a nominal amount - for example, a threshold of 90% could reasonably be considered "substantially all."

If the ATO's general approach is to be adopted, there should at least be consistency with the concept of "minor or insignificant," which, as noted above, we interpret differently from the ATO.

Commercial activities in connection with Australia

We disagree with the view that commercial activities exclude capital management or borrowing costs (e.g., establishment fees) (see paragraphs 103 and 107 of TR 2024/D3). The focus should be on whether activities have an Australian connection, rather than whether they meet a narrow definition of "commercial."

Expenses such as borrowing fees are a normal part of operating a business and obtaining finance. Funding these costs should clearly fall within the scope of commercial activities. Similarly, paying distributions and engaging in capital management are standard commercial practices for most businesses.

Where borrowings lack a clear commercial purpose, the ATO can apply existing integrity measures, such as Part IVA of the ITAA 1936. This is reflected in high-risk Example 28 of the draft PCG and case law, including ***Orica v FCT***[3], where the ATO successfully applied Part IVA.

[3] Orica Limited v FCT [2015] FCA 1399

The ATO seems to suggest at paragraph 104 that the requirement for debt to be used to fund commercial activities in Australia imports a nexus requirement that is different to and more restrictive than the nexus requirement in s8-1 of the ITAA 97. It is not clear that this is what Parliament intended (see comments on Example 15 below).

In Example 15 (paragraph 108), if the business of Bid Co is investing in entities like Target Co, the borrowing to acquire the shares in Target Co should meet the requirement of using the debt to fund commercial activities in Australia. The fact that Target Co has a foreign subsidiary should be addressed through other tests (e.g., recourse requirement)

PCG 2024/D3

Schedule 3

At paragraph 221, the requirement that Part IVA must not apply in order to adopt the compliance approach is impractical for taxpayers and significantly limits the utility of Schedule 3.

In practice, the application of Part IVA is often a key point of contention between the ATO and taxpayers - taxpayers generally do not adopt positions they believe Part IVA would apply to. This requirement introduces unnecessary technical complexity into the application of a PCG. The purpose of a PCG is not to assess technical risk but to provide taxpayers with confidence that certain factual arrangements will not be targeted by the ATO.

Taxpayers derive little certainty from compliance approaches that do not address the potential application of Part IVA. This is a primary concern for taxpayers considering restructuring arrangements to comply with the new law.

In Example 23 (para 246), unlike the previous section, the compliance approach is reflected in the criteria at paragraph 245 rather than being dependent on alignment with the example. Presumably the example is included for illustrative purposes only. However, the role of the example is not clear. At a minimum, the example should have an explicit conclusion. The ATO should clarify in this example the ATO would not apply compliance resources.

Schedule 4

There is a clear lack of practical examples. The only low-risk example provided is unlikely to have meaningful application. In practice, wholly owned Australian entities are almost always consolidated, and where they are not, it is typically for commercial reasons unrelated to the deductibility of interest.

Transitional compliance

Section 820-47 allows a choice to apply the TPDT to be made after lodgment day if permitted by the Commissioner (e.g., via an amended return) and permits revocation of a choice where the Commissioner considers it fair and reasonable. Given that the draft Ruling and PCG will be finalised well after the thin capitalisation rules take effect, we submit that the ATO should take a flexible approach, allowing taxpayers to change their decision- whether to make a previously unmade choice or revoke an existing choice - based on the final guidance.

Paragraphs 225 and 251 provide compliance approaches for restructures completed before “the end of the income year in which the Guideline is finalised.”

If the draft PCG is finalised in May or June, this would leave little time for 30 June year-end taxpayers- which include the majority of middle-market businesses - to interpret the guidance, seek advice, and implement necessary restructures.

To mitigate this issue, we suggest the ATO either:

- Delay finalising the PCG until at least early July, or
- Adopt an alternative criterion, such as allowing restructures completed within six months of the Guideline being finalised to qualify for the compliance approach.