Tax News & Insights

1 February 2025

OmniTax Professionals

Draft guidance and compliance approach – Third Party Debt Test

In December 2024, the ATO issued provisional guidance on the Third Party Debt Test ("TPDT") in TR 2024/D3 and PCG 2024/D3. This guidance sets out the Commissioner's draft views on the TPDT with a particular focus on the third party debt conditions, third party earnings limit, and restructures undertaken to comply with the third party debt conditions.

Overall, it is clear that the Commissioner will apply the TPDT narrowly and some genuine third party financing arrangements may not satisfy the third party debt conditions. Our "top ten" points arising from the Commissioner's draft views are:

a) **Back-to-back swap payments** by a conduit financier that hedge an existing financing arrangement are not included in the third party earnings limit. Consideration should be given to embedding such swap payments within the intra-group financing arrangement that is the subject of the hedge.

b) The **use of third party debt to make distributions to investors** is not regarded as "commercial activities in connection with Australia" despite the existence of the long-standing refinancing principle established in *Roberts & Smith*. The scope of application of the Commissioner's views outlined in the draft ruling is not entirely clear. Nonetheless, the restriction is similar to the restriction in the debt deduction creation rules, which applies when taxpayers rely on earnings-based tests for thin capitalisation purposes, rather than the third party debt test.

c) When considering whether a lender has recourse to foreign assets, it is necessary to **"look through" interests held in interposed Australian entities**. For example, where an Australian company with material Australian operations has some foreign assets that are not minor or insignificant, then a lender to the parent of the Australian company will be regarded as having recourse to the foreign assets and fail the third party debt conditions. Security packages for third party lenders should be appropriately reviewed when considering the third party debt conditions.

d) The third party debt conditions require a lender to only have recourse to Australian assets, other than "minor or insignificant" assets. The Commissioner views **"minor or insignificant" as meaning "minimal or nominal value"**. An example notes that even where the foreign assets of an entity represent 2% of a multinational group, the condition is breached as the foreign assets have a value of $10m, which is not of "minimal or nominal value".

e) The third party debt conditions need to be satisfied for the **entire income year** or the entire period that the relevant debt was on issue during the year. If a condition is breached for a part of the year, the third party debt conditions are failed for the entire year for that debt.

f) There is an **ongoing tracing requirement in relation to the "use" of funds** for the purposes of s820-427A(3)(d). This requirement is not a once-off test. An example in the draft ruling notes that if the taxpayer initially uses third party debt funds to invest in an Australian asset, then the taxpayer would need to "reassess how it continues to use those proceeds if the Australian asset is disposed of, and the proceeds of the sale are redeployed". This tracing requirement may seem more onerous and commercially impractical than the tracing requirement in the debt deduction creation rules.

g) The treatment of swap payments from arrangements that are not **conventional interest rate swaps** is not clear. In particular, it is not clear if such payments are within the third party earnings limit when paid to an unrelated party.

h) The **replacement of related party debt with third party debt** can be regarded as a high-risk restructure in certain circumstances, especially if the primary purpose of the restructure is to import deductible debt into Australia. The example provided is based on the collapse of conduit financing arrangements within a group of entities, with debt being borrowed directly from third party financiers.

i) Various examples of **low risk restructures** are identified including restructures to remove a margin on intra-group on-lending of project finance, creation of separate intra-group back-to-back loans, removal of a lender's recourse to foreign assets, and the closure of a foreign bank account.

j) It is likely that any restructures undertaken by taxpayers to comply with the third party debt test will be the subject of **ATO review**. Further, taxpayers may be required to disclose such restructures in international dealings and reportable tax position schedules. The international dealing schedule already includes an additional question on restructures of arrangements that would have attracted the debt deduction creation rules.

Submissions on TR 2024/D3 and PCG 2024/D3 are due by 7 February 2025.

Draft compliance approach – capital raised for franked distributions

In December 2024, the ATO issued PCG 2024/D4, which provides the Commissioner's draft compliance approach in relation to the integrity measure in s207-159 that operates to make certain distributions funded by a capital raising to be unfrankable.

The integrity measure is intended to discourage arrangements involving the raising of capital to fund the payment of franked distributions and the release of franking credits in a way that does not significantly change the financial position of the entity. The rule applies to arrangements that are entered into for a purpose (other than an incidental purpose) and principal effect of accelerating the release of franking credits to shareholders in circumstances that cannot be commercially explained by existing distribution practices.

Deductions for interest charges

Schedule 2 to the *Treasury Laws Amendment (Tax Incentives and Integrity) Bill 2024*, which is currently before the House of Representatives, will amend the law to deny income tax deductions for amounts of general interest charge and shortfall interest charge incurred by a taxpayer in income years commencing on or after 1 July 2025.

Build-to-Rent (BTR) developments

In December 2024, Schedule 1 to the *Treasury Laws Amendment (Responsible Buy Now Pay Later and Other Measures) Act 2024* enacted the long-awaited BTR concessions. The new rules increase the capital works deduction rate from 2.5% to 4.0% per year for eligible BTR developments and reduce the final withholding tax rate on eligible fund payments (distributions of fund payments and TAP capital gains) from eligible MIT investments from 30% to 15%.

In addition, the *Capital Works (Build To Rent Misuse Tax) Act 2024* has been enacted pursuant to which a BTR development misuse tax applies to claw back tax concessions which were obtained prior to the BTR development ceasing to be an active BTR development.

The ATO has also now released the approved form for notifying of events relating to eligible BTR developments. Events that the owner or purchaser of a BTR development must disclose on the form include commencement of an active BTR development, expansion of an active BTR development, sale of an ownership interest in an active BTR development, acquisition of an ownership interest in an active BTR development and ceasing to be an active BTR development.

Foreign resident CGT regime

Schedule 1 to the *Treasury Laws Amendment (2024 Tax and Other Measures No 1) Act 2024* contains amendments to the foreign resident CGT regime whereby from 1 January 2025:

- The foreign resident capital gains tax withholding rate has increased from 12.5% to 15%; and
- The $750,000 threshold before the withholding applies for transactions has been removed.

Note, the Commissioner may grant a variation to foreign residents on the 15% rate for reasons such as the capital gains tax payable on the sale is less than 15% of the price or a double tax treaty applies between Australia and the foreign country of tax residence. The variation can take 28 days to process.

Proposed deduction for small business meal and entertainment costs

The federal coalition, if elected in the upcoming federal election, will introduce a new tax deduction for small businesses' meal and entertainment expenses. Under the policy, small businesses with turnover of up to $10 million will be eligible for the tax deduction which will be capped at $20,000 for business related meal and entertainment expenses (other than alcohol). It is proposed that this measure will apply for two years and be exempt from FBT.

Contact

For more information and other updates, please visit our website at www.omnitax.com.au. Should you wish to discuss any matter or require any additional information, please email us on contact@omnitax.com.au.