30 October 2023

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Re: Exposure Draft Legislation – *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (Cth)

We are writing in response to the Government's Exposure Draft Legislation released on 18 October 2023 (**Exposure Draft Legislation**) which proposes amendments to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (the **Bill**) that was introduced into Parliament on 22 June 2023.

This is a joint submission made by the Ontario Municipal Employees' Retirement System (**OMERS**), Caisse de dépôt et placement du Québec (**CDPQ**), British Columbia Investment Management Corporation (**BCI**), and the Ontario Teachers' Pension Plan (**OTPP**) (collectively, the **Interested Canadian Investors**), with assistance from Ashurst, Australia.

The Interested Canadian Investors have consistently engaged with Government in respect of the Bill. The Interested Canadian Investors provided submissions dated 13 April 2023 in respect of the Exposure Draft Legislation released on 16 March 2023, and submissions dated 21 June 2023 to the Senate Standing Committee on Economics which we note are publicly available. Further, the Interested Canadian Investors have actively participated in a number of calls with Treasury throughout this process.
The Interested Canadian Investors recognise the improvements made by the Exposure Draft Legislation, and generally welcome the changes as proposed in the Exposure Draft Legislation.

However, the Exposure Draft Legislation needs to improve to ensure critical issues identified in the earlier phases of consultation are remedied, and ensure certain proposed amendments do not generate adverse implications. Accordingly, the submissions set out below outline the most important of areas for improvement to Treasury and the Government. The Interested Canadian Investors want to continue to work with the Government to ensure that the Bill will not deter investment, including investment from the Interested Canadian Investors, while ensuring that the Bill achieves its policy objectives.

The Interested Canadian Investors would welcome the opportunity to discuss this submission and our concerns with respect to the Exposure Draft Legislation with Treasury.

Section Reference	Issue	Description	Solution
Priority Issues			
820-427C	***Issue 1*** The former wording of subparagraph 820-427C(1)(d)(ii) in the Bill provided for multiple instances of on-lending within a group (i.e., multiple conduit financers). The amendments have given rise to a technical issue that would, in effect, prevent multiple instances of on-lending even if that on-lending would otherwise satisfy the conduit financing conditions. ***Issue 2*** Where an entity borrows from a conduit financer on back-to-back terms, and uses those funds to subscribe for equity in a downstream Australian entity, that is permitted by the conduit financing regime. However, if those funds are used to provide quasi equity to a downstream entity in the form of non-interest bearing debt, the conduit financing conditions will be failed. ***Issue 3*** Separately, the conduit financing conditions remain circular, which result in the requirements being technically failed in almost all instances.	***Issue 1*** The conduit financing conditions apply where the conduit financer issues an ultimate debt interest to the ultimate lender, and then one or more other entities which are associate entities of the conduit financer (and each other) issues a debt interest to the conduit financer (subsection 820-427C(1)(c)(i)) or another associate entity (subsection 820-427C(1)(c)(ii)). The amount loaned under each debt interest (each of which is a relevant debt interest), is, in instances where subparagraph (c)(i) applies, financed only with proceeds from the ultimate debt interest, or, in instances where subparagraph (c)(ii) applies, only financed with proceeds from "another borrower". The Supplementary Explanatory Memorandum (at [1.30]) notes that amendments 78 to 85 of the Exposure Draft Legislation are intended to clarify that the conduit financing conditions do not require every associate entity of a conduit financer to be a "borrower" and therefore subject to certain conditions, and to clarify that not every debt interest that a borrower issues is a "relevant debt interest". An entity is only a "borrower" if it is a an associate entity of the conduit financer, and issues a debt interest to the conduit financer or another associate entity. Therefore, the conduit financer is not "another borrower" when applying subparagraph (d)(ii), as it is not an associate of itself, and further it has not issued a debt interest to itself. Accordingly, where a conduit financer issues a debt interest to a third party, and on-lends the funds to Entity A on a back-to-back basis, and Entity A on-lends the funds to Entity B on a back to back basis, the on-lending from Entity A to Entity B will not be treated as a "relevant debt interest". It will therefore give rise to interest deductions that are non-deductible under the base third party debt test, and will also result in a failure of the conduit financing conditions (resulting in debt deductions of all the relevant entities being denied), which is contrary to the legislative intent of permitting multiple conduit financers. ***Issue 2*** In conduit financing structures, the ultimate borrower may apply borrowed funds to subscribe for equity in downstream Australian entities, which is permitted. However, it is also extremely common for the ultimate borrower to provide quasi equity to the downstream vehicles, in the form of non-interest bearing debt. This is often commercially preferred if the funds are only needed by the downstream entity for a short period of time (e.g., to pay expenses). Alternatively, funds may initially be provided by way of non-interest bearing loans, and then capitalised into equity at some regular interval – e.g., on an annual basis. Under the rules as drafted, and once the above issue is corrected, these arrangements may be classified as "relevant debt interests", and as they will fail the same terms requirement (because they are non-interest bearing), they will result in a complete failure of the conduit financing conditions. ***Issue 3*** One of the conduit financing conditions is that the ultimate debt interest satisfies the base third party debt test. The base third party debt test prevents the conduit financer from holding associate entity debt. The on-	***Solution 1*** Revert subparagraph 820-427C(1)(d)(ii) to that in the Bill, such that it reads: "*if subparagraph (c)(ii) applies – was financed by the other borrower only with proceeds from another debt interest that is a relevant debt interest (whether because of subparagraph (i) of this paragraph, or because of another operation of this subparagraph).*" The additional guidance in respect of the operation of this rule within the Supplementary Explanatory Memorandum should remain. ***Solution 2*** The concept of "relevant debt interest" should expressly exclude associate entity equity (as currently defined in Division 820). ***Solution 3*** Amend the language in subsection 820-427B(1) to ensure that section 820-427B is applied for the purposes of determining whether the requirements in section 820-427C are satisfied.

Section Reference	Issue	Description	Solution
		lending is likely to qualify as associate entity debt. Although section 820-427B modifies this, section 820-427B only applies where the conduit financing conditions are satisfied, including the requirement that the ultimate debt interest satisfied the base third party debt test. Section 820-427B needs to apply in determining whether the conduit financing conditions are satisfied, and not once the conditions are satisfied.	
820-49; 820-427C(3)	***Issue*** The recourse requirements in the third party debt conditions remain problematic, as they will: • be failed where there are any foreign assets (even if of de minimis value); • be failed if the recourse is against a foreign resident having granted specific security over membership interests in a member of the obligor group that is not the borrower; and • be failed where recourse provides access to third party guarantees or credit support that are not related to securing the debt, and arise in the ordinary course of business.	***Issue 1*** Security provided over a single non-Australian asset of de minimis value results in a complete failure of the third party debt conditions. ***Explanation*** It is extremely common for taxpayers to grant all asset security to external lenders in respect of lending. In such circumstances, a single foreign asset, for example, the borrower's right to receive an amount from a foreign entity (whether related or unrelated), or a foreign bank account, would result in the failing of the third party debt conditions, even where these assets were immaterial. This is entirely disproportionate to the policy objective, because lenders are not lending more to these entities because of immaterial non-Australian assets. **Issue 2** It should be permissible for a foreign entity to grant specific security over the membership interests in the borrower, as the specific security does not give the lender access to assets it could not obtain through exercise of its general security interest. In this sense, granting specific security over membership interests is not (in substance) credit support. However, the rules would draw a non-resident granting specific security over membership interests in the an entity within the obligor group who is not the borrower into the "obligor group" definition, with the consequence that the third party debt conditions would not be satisfied. This is illogical as, in both cases, there is (in substance) no credit support. ***Issue 3*** The third party debt conditions, in instances not involving a development asset, prohibit guarantees, security or other forms of credit support unrelated to obtaining the debt, as well as third party guarantees. ***Explanation*** In non-development asset circumstances, the third party debt conditions fail to account for genuine third party arrangements where an entity has provided a guarantee, security or other form of credit support to the borrower. To take some examples: • It is extremely common for entities undertaking a leasing business to receive, from a parent entity of a lessee (or an entity of substance within the lessee group), a guarantee of the lessee's obligations.	**Solution 1** Amend subparagraph 820-427A(3)(c) to permit non-material foreign assets which may arise from time to time, as follows: *"the holder of the debt interest has recourse for payment of the debt to which the debt interest relates <u>only or substantially only</u> to Australian assets…".* This change is required to facilitate granting all asset security, where that may include security over low-value assets that may arise from time to time (e.g., a foreign bank account or foreign receivable). ***Solution 2*** Amend subsection 820-49(3) to disregard assets that are membership interests in any entity in the obligor group. ***Solution 3*** Amend section 820-427A(3)(ca) to permit resident and non-resident guarantees, security and other forms of credit support as permissible security in instances where the arrangement is not entered into in respect of or to secure the debt, or, alternatively, exclude from that paragraph guarantees, securities, and credit support provided by entities that are not associate entities.

Section Reference	Issue	Description	Solution
		• It is extremely common for a lessee bond, or other form of security deposit, to be received by an entity undertaking a leasing business. Similarly, customer security deposits are common across a range of sectors, and these arrangements would appear to constitute a form of "security" or alternatively a form of "credit support". • It is extremely common for entities in the infrastructure sector to obtain bank guarantees which are funded out of Australian assets. These are third party arrangements, but because the guarantee, security, or credit support constitutes an asset of the borrower (or a member of the obligor group), these third party arrangements would result in a technical failure of the legislative requirements.	
820-427A(2); 820-427C	***Issue*** Deductions referable to common commercial swap arrangements with third parties may not be available due to technical gaps in the drafting of the third party debt test and conduit financing regime. ***Notes*** When considering the remaining issues in the Exposure Draft Legislation associated with interest rate swaps, it is necessary to understand common commercial and tax elements of swap arrangements. Please refer to the **Appendix 1** for a summary of the key principles.	The Exposure Draft Legislation proposes various amendments that would resolve some, but not all, of the issues previously identified for swaps. For example, the following issues appear to have been resolved: • if a borrower enters into an interest rate swap (or swaps) that hedges its exposure to a number of debt interests, and • if the borrower enters into a swap with a third party in respect of a loan borrowed via a conduit financer. However, fundamental issues remain with respect to common commercial swap arrangements that seek to hedge interest rate risk, under both the third party debt test and the conduit financing regime. ***Issue 1*** In the third party debt test (subsection 820-427A(2)), entities are prevented from entering into back-to-back swap arrangements with associate entities, as (1) the cost associated with the payment under the swap would be referable to an amount paid or payable directly or indirectly to an associate entity, failing paragraph 820-427A(2)(b), and (2) the payment by the conduit financer under the back-to-back swap with the ultimate lender is not attributable to the debt interest issued by the conduit financer (subsections 820-427A(1) and (2)(a)). This is the case, notwithstanding that the back-to-back swap reflects the terms of the external interest rate swap – i.e., reflects that the conduit financer is acting as a pure conduit both with respect to the loan, and with respect to the swap. ***Issue 2*** The application of the proposed amendments to cross-currency interest rate swaps are ambiguous, and it is not clear that cross-currency interest rate swaps would meet the requirements in section 820-427A(2)). In particular, the cross-currency interest rate swap hedges exposure to interest rate as denominated in a foreign currency, and may also hedge exposure to foreign exchange fluctuations. It is not clear that these arrangements give rise to debt deductions (with respect to the foreign currency part), and that (if they do) the	***Solution 1*** Debt deductions associated with hedging or managing risk (not just interest rate risk) in respect of one or more debt interests should be allowable, provided that the debt deductions are not referrable to an amount paid: • directly to an associate entity, unless the amount is paid indirectly to an entity that is not an associate entity; or • indirectly to an associate entity. Also, payments made by the conduit financer under a back-to-back swap to the ultimate borrower is a cost attributable to the debt interest issued by the conduit financer. ***Solution 2*** Amend the language in section 820-427A(2) to include a legislative note to clarify that terms relating to a cross-currency interest rate swap give rise to an allowable debt deduction. Alternatively, or in addition to the legislative note, the Supplementary Explanatory Memorandum should explain a cross-currency interest rate swap gives rise to permissible debt deduction. An example should be included to provide taxpayers with sufficient

<table>
<tr><th>Section Reference</th><th>Issue</th><th>Description</th><th>Solution</th></tr>
<tr><td></td><td></td><td>cross-currency interest rate swap is "directly associated with hedging or managing interest rate risk in respect of the debt instrument", as they hedge two potential fluctuations.

Issue 3

The use of the term "costs … that are a debt deduction" in paragraphs 820-427C(2)(d) and (e) only permits the conduit financer to recover from the ultimate borrower costs arising from the swap arrangement. However, swaps can also result in net receipts. To take an example, if the conduit financer enters into a floating to fixed interest rate swap, whereby it receives floating amounts and pays fixed amounts, an increase in the floating interest rate is likely to result in net receipts. As these amounts are not costs (they are income), they are not disregarded for the purposes of determining the "same terms" requirement, and so the conduit financer is not able to pass the amounts on to the ultimate borrower (who should bear the ultimate economic risk and rewards associated with the debt and swap arrangements).</td><td>guidance as to the application of the provisions to cross-currency interest rate swaps.

Solution 3

Amend the language in subsections 820-427C(2)(d) and (e), or insert an explanation in the EM, to clarify that the use of the word "costs", can be a net concept, and that a net benefit (i.e., when the swap is in the money) under a swap arrangement may be passed on.</td></tr>
<tr><td colspan="4">Other Issues</td></tr>
<tr><td>820-427A; 820-427A(4); 820-427A(6)</td><td>Issue

The proposed amendments will continue to discourage investment by foreign investors in development assets, including (in particular) certain renewable energy infrastructure, developments undertaken by controlled entities, and development assets more generally.</td><td>Issue 1

Subsection 820-427A(4) as amended by the Exposure Draft Legislation does not cover non-land assets and, consequently, certain infrastructure assets would remain ineligible for the Development Asset Concession.

Explanation

Proposed subparagraph 820-427A(4)(a)(i) effectively excludes assets that are not considered to be real property or land. This includes, for example, certain renewable energy projects, that should be (and are) considered by the Government to be critical infrastructure projects. As these infrastructure assets often do not qualify as interests in land (e.g., because they arise from license arrangements or they are investments in assets that are not fixtures), they will not generally qualify. A further issue arises in that, moveable property associated with infrastructure projects would be excluded on the basis that it is not "incidental". Conversely, the land is incidental to the infrastructure project's moveable property.

Issue 2

The Development Asset Concession continues to discriminate against non-residents providing guarantees, security or other forms of credit support in instances where the provider of such support holds a 50% or more interest in the borrower.

Explanation

We are unable to discern the policy objective behind the fact that a non-resident who holds less than 50% can provide a guarantee, security or other form of credit support in respect of a development asset, but a non-resident who holds 50% or more providing a guarantee would result in the failing of the third party debt</td><td>Solution 1

Amend subsection 820-420A(4) to permit the Development Asset Concession to also apply to non-land development assets that are (or will be) economic infrastructure facilities within the meaning of subsection 12-439(5) of Schedule 1 to the Taxation Administration Act 1953 (Cth).

Solution 2

Remove subparagraph 820-427A(4)(b), which will permit non-residents to provide guarantees, security or other forms of credit support in respect of development assets, where that non-resident holds a 50% or more membership interest in the borrower.

Solution 3

Amend paragraph 820-427A(4)(a) to permit the period to extent for a period beyond development – e.g., for 12 months following the completion of the development.</td></tr>
</table>

Section Reference	Issue	Description	Solution
		conditions. Guarantees are a standard part of sourcing third party debt for development assets, as the asset is subject to development risk and earns no income. The approach in the Exposure Draft Legislation will produce illogical outcomes. For example, a single member of the Interested Canadian Investors cannot provide support, but collectively, the Interested Canadian Investors as a consortium (each holding less than 50%) can. Further, an Australian entity may provide a guarantee, security and other form of credit support that would not result in the failing of the third party debt conditions, even if that Australian entity only held foreign assets (i.e., and the foreign assets provided comfort to the bank that the guarantee was from an entity of substance). ***Issue 3*** The Development Asset Concession, per the Bill, will cease to apply upon completion of the development of the relevant asset. ***Explanation*** Guarantees, security or other forms of credit support are permissible under the third party debt conditions only insofar as they relate to the 'development' of certain assets. While this is relevant for the development phase, the Bill fails to permit common security arrangements in respect of development assets by not extending the period through to the stabilisation of the income arising from the development asset. Guarantees, security and other forms of credit support will often (if not always) be granted to external lenders until such time that the asset is stabilised and income producing. With respect to the Development Asset Concession, this would result in the third party debt conditions being satisfied during the period of development, but then the third party debt conditions being failed once development has completed. This guarantee will then fall away at stabilisation and the third party debt conditions may be able to be satisfied – but it is not clear why for that short period of time (e.g., 18 months), there should be a failure of the conditions.	
820-52; 820-55; 820-60	***Issue*** The proposed amendments to permit excess thin capitalisation capacity to flow upstream, while welcome to the extent they are available, are unnecessarily limited by reference to entity type, level of required interest, and also apply only to the fixed ratio test. ***Change***	***Issue 1*** The "Trust excess tax EBITDA" rule does not permit the utilisation of excess thin capitalisation capacity, by way of excess tax EBITDA, arising from partnerships or companies, or arising for partnerships or companies in other entities. ***Explanation*** The rule should be agnostic as to the character of the entity. We note, the proposed rule is particularly discriminatory in respect of partnerships (which cannot form tax consolidated groups), and which are extremely prevalent in Australian infrastructure projects. In addition, holding real estate assets by way of tenants in common interests (which, again, is very common) may result in a general law partnership or a tax law partnership arising. Accordingly, discriminating against downstream partnership is expected to have	**Solution 1** Expand paragraph 820-52(1)(ca) to include partnerships and companies. Amend section 820-60 to similarly permit upstream entities to pick up excess tax EBITDA from partnerships and companies. ***Solution 2*** Amend paragraph 820-60(2)(a) to require that the TC control interest threshold is 10% or more, equal to the threshold to be associate entities in subsection 820-52(9). At the very least, this threshold should be

Section Reference	Issue	Description	Solution
	The Exposure Draft Legislation introduces section 820-60, which includes in the calculation of tax EBITDA an amount for "Trust excess tax EBITDA". This provision permits a trust, which is a resident trust for CGT purposes or a managed investment trust (**MIT**), that has not made an election to apply either the group ratio test or the third party debt test, to include controlled downstream trusts' excess thin capitalisation capacity. Trust excess tax EBITDA amounts arise where a controlled trust has a fixed ratio earnings limit which exceeds the sum of its net debt deductions for the income year and its total FRT disallowed amounts for the 15 income years prior. The controlled trust must also be a resident trust for CGT purposes or a MIT, and it must not have made an election to apply the group ratio test or third party debt test (or deemed to have applied the third party debt test).	material adverse impacts on the project economics of significant Australian infrastructure assets and material real estate assets, thus deterring foreign and domestic investment. **Issue 2** The control threshold to enliven the Trust excess tax EBITDA rule unfairly discriminates against upstream entities that hold greater than a 10% interest but less than a 50% interest. ***Explanation*** Upstream entities holding an interest of 10% or more are required to exclude from their tax EBITDA income arising from holding an interest in the downstream entity. In other words, their tax EBITDA is depressed as they hold interests in income producing assets indirectly, rather than directly. In order to pick up any excess thin capitalisation capacity from downstream entities, however, they are required to hold 50% or more. Accordingly, upstream entities holding non-portfolio non-controlling interests (i.e., between 10% and 50%) are unfairly treated compared to those holding portfolio interests or those holding controlling interests. This is particularly the case for institutional investment in large assets (e.g., infrastructure and material real estate assets), where it is extremely common to hold interests of less than 50% but more than 10%. These entities will, in effect, be denied access to the default fixed ratio test, as they are likely to have limited, or no, tax EBITDA. ***Issue 3*** The "Trust excess tax EBITDA" rule does not apply to an upstream entity that has elected to apply the group ratio test. Accordingly, entities with upstream gearing will be unable to access the group ratio test. ***Explanation*** Entities applying the group ratio test apply the relevant accounting ratio to their tax EBITDA in determining their group ratio earnings limit. However, "Trust excess tax EBITDA" only applies for the purposes of the fixed ratio test, meaning that entities with upstream gearing are (in effect) limited in seeking to apply the group ratio test. There is no logic to this approach, given that "Trust excess tax EBITDA" only arises if there is gearing at a downstream level below the group ratio.	further reduced - .e.g., to 20% to reflect common investment holdings in large assets (e.g., infrastructure and real estate). ***Solution 3*** Amend paragraph 820-60(1)(c) to remove the reference to the group ratio test election.
820-423A(5); 820-423A(5A)	***Issue*** As a result of the amendments, various technical issues arise that would result in the application of the debt deduction creation rules	There is another material issue with the debt deduction creation rules in respect of intragroup funding, where non-consolidated entities require funds for genuine commercial reasons (i.e., third party expenses and costs) that may be incurred by upstream or downstream entities. It is very common in such instances for intragroup funding to occur by way of non-interest bearing loans. To take a scenario, consider a conduit financer that on-lends to a holding trust. The holding trust then advances funds on a non-interest bearing basis to a subsidiary trust. The amendments make it clear that	The following key changes should be made: • Make it clear that payments arising in respect of debt interests that are classified as associate entity equity are excluded from the debt deduction creation rule contained in subsection 820-423A(5);

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<tr><td></td><td>to very common intragroup arrangements.</td><td>advancing principal under a loan constitutes a "payment", as otherwise there would be no need to exclude certain arrangements relating to advancing or repaying principal. This payment would not be covered by the exclusion from the rules in subsection 820-423A(5A), as the on-lending of the principal is not on the same terms as the borrowing as it is non-interest bearing. This would result in all debt deductions on any debt drawn to on-lend on non-interest bearing terms being non-deductible. This seems a particularly odd outcome in that if the on-lending was on interest bearing terms (i.e., there was creation of more debt deductions), this would be permissible. Under the current thin capitalisation rules, on-lending on a non-interest bearing basis will generally be treated as "associate entity equity", reflecting that this form of finance is (in substance) quasi equity. Accordingly, payments made in respect of debt interests that are associate entity equity should be excluded from the operation of the debt deduction creation rules.

Other technical issues include:

• The non-inclusion of the use of funds being predominantly to fund, facilitate funding or increasing ability to make a payment. The Bill included the word "predominantly", but the Exposure Draft Legislation could result in the application of the debt deduction creation rules where only a very small amount of the borrowed amounts are used in this manner.

• It is not clear if "payment" would encapsulate the subscription for equity (noting that subsection 820-423AA(1) only applies to subsection 820-423A(2)). Where the concept of "payment" includes a subscription for equity, then none of the exclusions from the debt creation rules would apply where an ultimate borrower borrows from a conduit financer, and capitalises their subsidiaries with the on-lent funds. This is clearly not intended, but appears to be captured by the legislation.

• The requirement in subsection 820-423A(5A)(d) that the earlier debt interest be on the same terms as the debt interest in subsection 820-423A(5A)(a) does not align with the requirement that on-lending be on the same terms within the conduit financing conditions. That is, the costs that are to be disregarded under the conduit financer rules are not disregarded under the debt deduction creation rules, raising the prospect that a debt meeting the conduit financing requirements fails the debt deduction creation rules (resulting in debt deduction denials when the arrangement is a back-to-back arrangement).</td><td>• Re-introduce the "predominantly" requirement;

• Make it clear that payments arising under subscriptions for new equity interests are excluded from the second debt deduction creation rule; and

• Make it clear that the "same terms with respect to costs" requirement is to be assessed using the same disregarding costs criteria in the conduit financer rules.</td></tr>
<tr><td>820-427E</td><td>The modified meaning of Australian partnership will arbitrarily limit access to the third party debt test</td><td>The requirement that 50% or more of the partnership interests are directly held by an Australian resident or Australian trust artificially limits access to the third party debt test, with no clear rationale. Where an Australian partnership (as defined in the ITAA 1936) has a majority of interests held by non-residents, those non-residents still pay tax on Australian sourced income, and the partnership should have access to the third party debt test. This would be the same ultimate position regardless of whether the foreign investor(s) invested via an Australian entity or not.</td><td>Remove the modification to the definition of Australian partnership and potentially include a requirement that the partnership is formed in Australia or carries on business in Australia (i.e., similar to the requirement in section 94T of the ITAA 1936) or, alternatively, reduce the relevant threshold to, for example, 20%.</td></tr>
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Appendix 1 Key principles of swaps

When considering the issues with the Exposure Draft Legislation approach to swaps, please note the following key principles relating to swaps:

- Interest rate swap arrangements may hedge interest rate exposure in respect of a particular debt interest or in respect of multiple debt interests. In addition, interest rate swaps may fully hedge the exposure (i.e., where the notional principal is equal to the principal of the debt interest or debt interests), or may partially hedge exposure (i.e., where the notional principal is less than the principal of a debt interest or debt interests).

- Swaps, more generally, may hedge multiple exposures. For example, a cross-currency interest rate swap hedges the interest rate as expressed in a foreign currency. Cross-currency interest rate swaps where there is an exchange of notional principal also hedge (more generally) foreign exchange rate fluctuations.

- In circumstances not involving a conduit financer, it is common (although not always the case) that the borrower would be the party that enters into the interest rate swap arrangement. In circumstances involving a conduit financer, the following swap arrangements would be common:

    - A swap is entered into not by the conduit financer, but by the entity to which the conduit financer on-lends. In this circumstance, the conduit financer is not (overall) exposed to interest rate fluctuations, as it on-lends on the same terms (with respect to interest rates) as it borrows on. Accordingly, the real exposure to interest rate fluctuations rests with the ultimate borrower, and the ultimate borrower enters into the relevant swap arrangements.

    - Alternatively, the conduit financer may enter into the relevant swap arrangements. In this circumstance, and noting that the conduit financer is typically expected to be a pass-through entity, the conduit financer would be exposed to interest rate fluctuations with respect to its on-lending (e.g., if it had borrowed and on-lent at a floating rate, and had entered into a floating to fixed interest rate swap with a third party, it would (in effect) not be able to finance the payments under the swap if floating rates reduced). Accordingly, to maintain its status as a pass-through vehicle, it may enter into a back-to-back interest rate swap with the ultimate borrower.

    - As an alternative to the above, the conduit financer could on-lend to the ultimate borrower by reference to its hedged exposure. For example, if the conduit financer has borrowed at a floating rate, and fully hedged its exposure to interest rate fluctuations by entering into a floating to fixed interests rate swap with a notional principal equal to the principal of the debt interest, it may on-lend to the ultimate borrower on a hedged basis – i.e., with a fixed interest rate, and where its receipts under the swap exceeds its cost (e.g., because the swap is in the money), it would also pass those swap benefits on to the ultimate borrower. Otherwise, the internal arrangement would effectively be one sided – costs may be recovered from the ultimate borrower, but swap benefits are not passed on. Arm's length parties would not enter into an arrangement of this nature..

    - A swap generally gives rise to two different legs – a payment leg, and a receipt leg. In an interest rate swap, for example, if the swap hedges exposure to a variable interest rate, the taxpayer will be required to pay an amount by reference to a fixed interest rate on the notional principal, and will receive a floating interest rate on the notional principal. Commercially, these payment obligations and receipt rights are typically netted, so only the net amount is received or paid. For tax purposes, it is the gross payments under the legs of the swap that are relevant, rather than the net payment or receipt. The gross payments required to be made under the swap should be allowable deductions under the TOFA regime (on a compounding accruals basis), and the gross receipts to be received are treated as assessable income under the TOFA regime (on a compounding accruals basis).