22 November 2024

Stephen Dodshon
Acting Assistant Commissioner
Public groups
Australian Taxation Office

By email: stephen.dodshon@ato.gov.au

Dear Stephen Dodshon,

PCG 2024/D3 - Restructures and the new thin capitalisation and debt deduction creation rules - ATO compliance approach (draft PCG).

The Tax Institute and Chartered Accountants Australia and New Zealand (together, the **Joint Bodies**) welcome the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft PCG.

In the development of this submission, we have closely consulted with our tax committees to prepare a considered response that represents the views of our broader memberships.

The debt deduction creation rules (**DDCR**) contained in Subdivision 820-EAA of the *Income Tax Assessment Act 1997* (**ITAA 1997**) deny deductions where they relate to a debt creation scheme. The Explanatory Memorandum (**EM**) to the Treasury Laws Amendment *(*Making Multinationals Pay Their Fair Share - Integrity and Transparency*)* Bill 2023 *(***Bill**) that introduced the DDCR, states that the DDCR were needed to supplement the operation of the changes to Division 820 of the ITAA 1997 (interest limitation rules) as the interest limitation rules do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. This is on the basis that such debt deductions would only ever be indirectly and at most partially restricted by the interest limitation rules.

We also note that paragraph 2.146 of the EM states that the schemes to which the DDCR are targeted are "debt creation schemes that lack commercial justification". More specifically, the EM states that the DDCR:

- disallow debt deductions where artificial interest-bearing debt is created within a multinational group, which over time allows for profits to be shifted out of Australia in the form of tax-deductible interest payments (paragraph 2.149); and
- have been drafted broadly to help ensure they are capable of applying to debt creation schemes of varying complexity. This is stated to be necessary due to the ability of multinational groups to enter into complex debt creation arrangements (paragraph 2.153).

In our submission we have been guided by:

- the policy objectives and approach to the drafting of the DDCR;

- the need to ensure that the DDCR do not apply to mere restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules;
- comments made by Deputy Commissioner, Policy, Analysis and Legislation, Mr Ben Kelly to the Senate Economics Legislation Committee on 31 January 2024, regarding the ATO's general approach (to not apply the integrity rules in the proposed measure or elsewhere) to situations where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law (i.e. during the transitional period);
- the general role of ATO Practical Compliance Guidelines (**PCGs**). We note that PCGs "[…] represent material on how the ATO will allocate its compliance resources according to assessments of risk and may outline administrative approaches that mitigate practical difficulties relating to the operation of tax laws." (PCG 2016/1 - PCGs: role in ATO's public advice and guidance, paragraph 23); and
- the need for certainty for taxpayers.

The Joint Bodies appreciate the ATO's engagement with stakeholders during the consultation that helped formulate the examples set out in the Schedules in the draft PCG. However, our members are concerned that there appears to be a disconnect between the intended target of the relevant integrity provisions in relation to restructures carried out in response to the DDCR as per the EM, and the draft PCG's classification of the examples in the various risk zones and ATO compliance approach. In particular, we are concerned with the classification of the simple restructure of replacing related party debt with third-party debt as high risk. Our detailed comments are set out in **Appendix A**.

If you would like to discuss any of the above, please contact The Tax Institute's Senior Counsel – Tax & Legal, Julie Abdalla on (02) 8223 0058 or Chartered Accountants Australia and New Zealand's Senior Tax Advocate, Karen Liew, on (02) 8078 5483.

Yours faithfully,

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APPENDIX A

We have set out below our detailed comments and observations on certain aspects of the draft PCG for your consideration.

Restructures to comply with the intent of the new law

While we acknowledge that the EM notes that the DDCR are intentionally drafted broadly, our view is that due consideration should be given to including additional or clarified examples that clearly address restructures that are carried out in order to comply with the intention of the new law and are classified as low risk because, for example, there is no net increase in debt or "creation of" debt deductions.

In this regard, we consider that the views expressed by Mr Ben Kelly, Deputy Commissioner, Policy, Analysis and Legislation (**Deputy Commissioner**) to the Senate Economics Legislation Committee on 31 January 2024, recorded in Hansard p18, should be taken into account when considering the ATO's approach to enforcing the DDCR. We further consider that these views should be more explicitly reflected in the guidance in the draft PCG:

> […] as a general principle, the ATO would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law.

The Chair requested the Deputy Commissioner confirm that the ATO would be taking:

> a sort of understanding type approach […] during the transition.

The Deputy Commissioner confirming the Chair's understanding of the ATO's proposed approach during the transitional period and stated that:

> [t]hat's right. Where there is that restructuring to ensure that the taxpayers are complying with the intent of the new measure, that will be our general approach.

In addition, the Supplementary EM in respect of the amendments to the Bill stated at paragraph 1.44:

> […] these rules are not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be *caught by the debt deduction creation rules.*

While we recognise that the draft PCG, at paragraph 43 refers to paragraph 1.44 of the Supplementary EM to the Bill, our view is that the above comments should be considered and inform the finalisation of the draft PCG and its provision of indicative risk zones. In particular, having regard to the above, taxpayers would expect that a mere restructuring out of any existing financing arrangement that may otherwise be caught by the DDCR generally would be considered low risk, provided that there is no artificiality or contrivance associated with that restructure. As currently drafted, this is not, in our view, clearly reflected in the draft PCG and we recommend that this point is expressly made. This could be achieved by introducing a new example that is similar to Example 19 but does not include the bank debt issued by B-Co or the associated interest rate swap between Aus-Co and C-Co. Example 19 could then be used to differentiate between:

- restructures involving no artificiality or contrivance to confirm that the DDCR do not apply (within the intent of the law and therefore to be appropriately considered low risk for the purposes of the draft PCG); and
- restructures that have some artificiality or contrivance remaining within the "scheme" as identified (not within the intent of the law, and therefore considered higher risk as currently contemplated by Example 19).

In our view these enhancements to the existing examples would create greater certainty for taxpayers regarding the steps that can be taken to restructure existing arrangements within the intent of the law.

Interaction with the consolidation regime

We have received feedback from our members that certainty for taxpayers could be enhanced by ensuring that the interaction between the consolidation regime and the DDCR is addressed and factored into a number of the Examples in the draft PCG.

Interaction with paragraph 820-423A(2)(a) of the ITAA 1997

It would be helpful for the draft PCG to explicitly address the interaction of paragraph 820-423A(2)(a) of the ITAA 1997 and the consolidation regime, in particular section 701-1 of the ITAA 1997, which contains the single entity rule (**SER**).

Paragraph 820-423A(2)(a) of the ITAA 1997 provides that an entity is taken to *"acquir[e] a CGT asset, or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities"*. The SER effectively ignores the separate entity status of the subsidiary members of a consolidated group and treats the subsidiary members as being part of the head company for the purposes of working out the head company's tax liability for the year. Our view is that it is not clear how it would be possible for the requirement for an *"acquisition"* in paragraph 820-423A(2)(a) to be satisfied where a transaction arises between members of a consolidated group. Accordingly, our view is that in such circumstances the DDCR do not apply.

This is a relevant consideration where, for example, a debt deduction relates to a debt interest between entities that are not members of the same consolidated group, but where the debt deduction is wholly or partly in relation to an acquisition as between members of a consolidated group.

Our view is that this aspect of the operation of the DDCR should be included in the draft PCG as an explanation of the interaction of the two sets of rules and because it may impact a number of examples in the draft PCG, including Example 8.

Interaction with paragraph 820-423A(5)(b) of the ITAA 1997

A further concern involves the interaction between paragraph 820-423A(5)(b) of the ITAA 1997 and the consolidation regime. The SER requires subsidiary members to be treated as parts of the head company for the purposes of working out the head company's tax liability for the year. Paragraph 820-423A(5)(b) of the ITAA 1997provides that an entity is taken to make *"one or more payments or distributions […] to an entity […] that is an associate pair of the payer"*. It is unclear how such a situation could arise where the two parties to that arrangement are both members of the same consolidated group. Accordingly, our view is that, in such circumstances, the DDCR do not apply.

This is a relevant consideration, where, for example, a financial arrangement exists between entities that are not members of the same consolidated group, but the financial arrangement is used to fund or facilitate the funding of a payment or distribution as between members of a consolidated group.

Our view is that this aspect of the operation of the DDCR should be included in the draft PCG as an explanation of the interaction of the two sets of rules, and also specifically in relation to Example 2.

Risk Zones

The draft PCG defines "restructure" expansively. It includes "any refinance, any change or reorganisation of group structure, business affairs or financial arrangements. Restructure includes any part of a broader restructure or a restructure that is part-way through and yet to be completed" (draft PCG, paragraph 2, footnote 2).

Our members have expressed concerns with the draft PCG's approach to classifying restructuring types across the various risk zones.

White Zone

While we recognise that the white zone criteria are intended to identify arrangements where "further risk assessment is not required," our members have expressed concerns that the draft PCG, particularly as currently outlined in paragraphs 53 to 56, does not account for situations in which a taxpayer has proactively engaged with the ATO and obtained confirmation—either through administrative guidance or a private binding ruling—that an arrangement is not subject to anti-avoidance provisions.

Under the draft PCG, even with this level of engagement and assurance, such arrangements would at best only qualify for green zone (low-risk) status, which means the arrangements are still potentially subject to further compliance action. The approach in the draft PCG may inadvertently overlook the practical value of taxpayer-initiated early engagement processes, and could diminish the white zone's value in clearly signalling compliance assurances for low-risk cases.

We further note that paragraph 56 of the draft PCG acknowledges that few taxpayers are expected to have restructures in the white zone in the early stages of implementing the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024* (**Act**). This may reduce the immediate utility of the draft PCG as a compliance resource. Additionally, the anticipated timelines involved in ATO assessment, objection processes, and potential court proceedings could present further challenges for taxpayers seeking to achieve white zone status for restructures. These extended timelines could impact the draft PCG's practical value for taxpayers and advisers, potentially limiting its effectiveness as a timely and reliable guide for assessing compliance risks in restructuring arrangements. We suggest that the allocation of restructures to risk zones is further considered before finalising the draft PCG. The white zone should be designed in such a way that it is capable of accommodating a reasonable number of taxpayers' restructures during the early stages of implementation of the Act rather than only a few.

Yellow Zone

Stratified approach to risk-zoning

It is expected that most restructuring arrangements will likely fall into the "yellow zone". This means that there is a risk that the ATO may still scrutinise a very large group of taxpayers and their efforts to replace related-party debt with deductible debt, even in cases reflecting common commercial practices. We consider that it would be more useful for the draft PCG to incorporate sub-categories within the risk zones to provide a clearer delineation of the yellow zone. As it currently stands, the broad scope of the yellow zone may reduce its practical value; a more refined risk-zone structure could enhance its clarity and utility for taxpayers, so that it is not merely a default zone. We also note that the draft PCG, at paragraph 58, provides that the ATO "[…] *may engage with you to understand the compliance risks of your restructure*" in relation to the yellow zone. In order to increase certainty for taxpayers, and achieve a more stratified approach to risk-zoning in the draft PCG, we consider that these "compliance risks" should be clearly identified and that they should be allocated to a distinct risk-zone.

We also suggest an alternative category be provided within the green zone which could apply to taxpayers with related party debt deductions not exceeding a certain threshold. We note that the inclusion of a materiality threshold would be consistent with the approach taken by the ATO in PCG 2021/5: Imported mismatch rule – ATO's compliance approach, paragraph 64(d), where one of the green zone factors is that the 'otherwise deductible payments' made to members of the Division 832 control group are less than $2 million.

Broad application of the yellow zone reduces the utility of the draft PCG

The yellow zone is characterised as "compliance risk not assessed" (paragraph 51, Table 1) and broadly includes restructures that are not covered by the green (low risk) or red (high risk) zones (paragraph 57). Additionally, the draft PCG notes that ATO engagement may be warranted to assess compliance risks for restructures that fall within the yellow zone (paragraph 58). While we acknowledge the breadth of the legislation, we consider that the draft PCG's practical value may be reduced if an overly broad application leads to ambiguity over which arrangements warrant ATO engagement.

The role of PCGs, as outlined in PCG 2016/1, is to provide guidance on where the ATO will allocate compliance resources based on risk assessments and may offer administrative approaches to ease practical challenges associated with tax law. We consider that the possibility that a large portion of restructures could fall into the "yellow zone" may reduce the draft PCG's practical significance for taxpayers. Rather than guiding taxpayers on clear risk distinctions, without certain changes, it may instead increase uncertainty around the likelihood of ATO compliance activity across a wide spectrum of restructuring activities.

Furthermore, our members report that in their experience the most common type of restructure involves replacing related party debt with third party debt. This is an ordinary commercial dealing. We are unclear (particularly having regard to our comments under the heading "Restructures to comply with the intent of the new law") as to why such an ordinary commercial arrangement that can be expected to occur frequently in the market would not generally fall within a risk zone that attracts less of a compliance concern than the yellow zone.

An example would entail a US world-wide parent entity that borrows funds in the global markets for general working capital purposes and on-lends those funds to its world-wide subsidiaries, including an Australian subsidiary, in proportion to their relative business activities and at arms-length rates. By borrowing in this way, the US parent can obtain debt funding at lower rates than if each of its subsidiaries borrowed separate amounts from third parties. If the Australian subsidiary previously paid dividends out of unrealised profits using the cash from the working capital facility provided by its US parent, the debt may be subject to the debt deduction creation rules. Alternatively, the Australian subsidiary may not have sufficiently detailed records to substantiate the precise uses of the cash borrowed under the facility. The Australian subsidiary's business cannot sustain paying non-deductible interest on a long-term basis. The US parent cannot reduce the interest rate on the loan in compliance with US transfer pricing rules. The obvious choice for the Australian subsidiary to maintain its business is to replace the loan from its parent with third party debt. There is no increase in, or "creation of", debt in this case. This should, therefore, be a "low risk restructure".

Red Zone

Paragraph 61 of the draft PCG sets out when restructures will fall within the red zone and states that:

You are in the red zone if any of your restructures in response to the DDCR are in the following categories:

- Your restructure (including any part of a restructure) in response to the DDCR in the income year is covered by a high-risk examples in Schedule 2 to this Guideline;

- We have conducted a review or audit of your restructure and provided you with a 'high risk' rating (or 'low assurance' under a Justified Trust review)".

We consider that there is some ambiguity as to when an arrangement "is covered" by a high-risk example. In particular, it would be useful to know whether all the facts need to align or whether it is sufficient if only some features are present. Accordingly, it would be useful if the draft PCG provided further guidance in this regard.

We also consider that certainty for affected taxpayers and their advisers would be increased if the draft PCG were to include a list of specific factors that the ATO considers to be "high-risk". One suggestion is to include factors relevant to the examples listed in the draft PCG at paragraph 204.

We also consider that as currently worded, the approach outlined in paragraph 203 may unreasonably capture arrangements in the high-risk zone (i.e. the red zone). Given that paragraph 203 refers to a situation where an entity has similar debt levels both before and after a restructure as being expected to be a "high risk restructure", it appears to potentially capture a situation where an entity merely replaces related party debt with third party debt as falling within the high-risk category.

Furthermore, we consider that the statement in the draft PCG at paragraph 204 introduces ambiguity by stating that "higher risk arrangements may include a contrived arrangement to choose and use the TPDT under subsection 820-46(4) with the purported effect of preventing the DDCR from applying." We consider that further clarity is needed, either by incorporating specific examples and additional detail on high-risk arrangements within this context, or by removing the statement entirely to avoid unnecessary uncertainty.

The Third Party Debt Test (**TPDT**) is principally concerned with limiting debt deductions for debt interests that fail to meet third-party debt conditions. However, a choice to apply the TPDT enlivens a distinct set of conditions, which in turn impose consequential limitations on debt deductions. In our view, a taxpayer should retain the freedom to make this choice, thereby subjecting itself to those alternative conditions, even if the result is that the DDCR do not apply, without automatically invoking an anti-avoidance provision.

In practice, it will likely become commonplace for taxpayers to structure their arrangements to ensure that the TPDT will be available (as opposed to the fixed ratio test in combination with the DDCR). Many may proactively negotiate or adjust finance documents and security arrangements, intending to retain access to the TPDT over the fixed ratio test with the DDCR. For instance, a taxpayer may structure their debt in a manner that meets the TPDT conditions, anticipating that they could later engage in acquisitions, payments, or distributions with associate pairs that would otherwise fall within the scope of the DDCR.

As currently drafted, paragraph 204 in the draft PCG appears to imply that taxpayers selecting the TPDT could face anti-avoidance challenges, which generates significant uncertainty. Including a concrete example of a high-risk scheme, that reflects the intent of paragraph 204, would greatly enhance clarity for taxpayers. Without such elaboration, we consider that the interests of certainty are best served by removing paragraph 204 entirely.

At a more general level, we consider that the draft PCG would have greater utility if it included an example where the ATO concludes that the specific or general anti-avoidance provisions would apply to the restructure in the circumstances. Having such an example would provide taxpayers and advisers with greater clarity as to the basis for which such restructures would be considered to be high risk transactions. We recommend that such an example is included.

Documentation requirements

Historical transactions

The position under the draft PCG is that the onus is on the taxpayer to prove that the DDCR do not apply. The discharge of this onus can be achieved by providing information and documentation to the ATO, as outlined in paragraph 143 of the draft PCG.We consider this to be an overly stringent approach, especially for historical transactions. Paragraph 144 of the draft PCG states the ATO's view is that it is neither feasible nor appropriate to exempt historical transactions occurring before a specific timeframe (such as more than five years prior to the enactment of the DDCR, as suggested by some stakeholders) from the requirement to provide business records to satisfy the taxpayer's onus. However, we consider that there should be some concession in this respect given that tracing as contemplated by the DDCR has not been previously required to be undertaken. In many cases, taxpayers will not have relevant or sufficiently detailed records because taxpayers did not know that they had to keep such records at the time. We also note that the DDCR were an unexpected addition to the Bill. Accordingly, we consider it reasonable for the draft PCG to include a carve-out from the documentation requirements for historical transactions arising before a five-year period that ends on the day the DDCR apply (i.e. there would be no documentation requirements for historical transactions arising before 1 July 2019). Such an approach would align the record keeping requirements for historical transactions with the standard minimum five-year record keeping requirements.

Additionally, we consider that the position is compounded in cases where a taxpayer seeks to replace debt that cannot be clearly excluded from the DDCR with third-party debt. Such a situation could be classified as a no-risk scenario, as the primary purpose of the arrangement in these cases would be to eliminate the uncertainty surrounding the historical transaction that might otherwise be "at risk". We therefore consider that due consideration should be given to adopting a safe harbour or *de minimis* approach within the draft PCG for such situations. For instance, a reasonable *de minimis* approach could be based on the proportion of debt deductions at risk relative to total debt deductions to which the DDCR do not apply. Examples of documentation

We recognise the importance of documentation requirements in the ATO's compliance approach and support the examples in paragraph 142 of the draft PCG to assist taxpayers in substantiating historical transactions. We recommend that these same examples be applicable not only to historical transactions but also to transactions entered into after the DCCR's application date.

Guidance on what the ATO considers is best practice to manage potential compliance risks and in dealing with the challenges of tracing funds would be welcomed. For example, the use of separate bank accounts and/or policies to prevent the blending of borrowed funds with operational funds.

Examples

We welcome the inclusion of examples in the draft PCG as a means of providing greater certainty for taxpayers. However, we consider that there is scope for additional examples to be included, and for the concerns raised in relation to Example 19 below to be addressed.

New example

We consider the draft PCG would be of greater utility if it covered one of the most common types of restructures that taxpayers undertake. That is, merely replacing related party debt with third party debt under ordinary commercial terms, where it is not undertaken in any artificial or contrived manner. Taxpayers that have historical debts still in existence but are unable to positively determine that the DDCR do not apply will most likely look to remove that debt or replace it with third party debt. In our view, including an example contemplating such a scenario with relevant ATO categorisations would assist taxpayers to accurately self-assess.

Example 19

We consider that Example 19's utility could be enhanced by clarifying its scope of application. As currently drafted, it appears that the arrangement in Example 19 is classified as one of "dumping debt into Australia" in spite of the fact that the transaction does *not* appear to affect the net debt position of any entity in Example 19, or the group.

Furthermore, we are unclear whether the inference that should be read into Example 19 is that the arrangement is "at risk" as the arrangement may involve a round robin of funds involving Bank Co. It would be helpful if this aspect of Example 19 could be clarified.

We are also of the view that when Example 19, as currently drafted, is considered from a conduit financing perspective, it appears to suggest that up until such time as AusCo holds no debt, there is no course of action open that would eliminate all risk of such an arrangement attracting ATO attention. This extends to the simple removal of the conduit lender (i.e. B Co). We recommend that the wording in Example 19 is amended to ensure that Example 19 does not leave open the possibility of such an interpretation.

Please also refer to our suggestions above in relation to Example 19 above under the "Restructures to comply with the intent of the new law" heading where we recommend that:

- a new example (that is similar to Example 19 but does not include the bank debt issued by B-Co or the associated interest rate swap between Aus-Co and C-Co) be included in the draft PCG; and
- consequently, Example 19 be targeted to clearly demonstrate the boundary between restructures involving no artificiality or contrivance (to ensure that the DDCR do not apply as these are within the intent of the law and should, therefore, be "low-risk") and restructures that exhibit some artificiality or contrivance within the "scheme" (to indicate when the DDCR may apply as these may not be within the intent of the law and so may be considered high-risk).

Further examples to deal with Division 7A loans

We welcome the inclusion of two examples dealing with Division 7A complying loans arising from the trustee borrowing from a private company within the same group to fund potentially in scope transactions.

Unpaid present entitlements and Division 7A loans

However, there is no example dealing with the situation where a trustee has made a private company beneficiary presently entitled to a trust distribution but has not paid the distribution to the company (i.e. there is an unpaid present entitlement (**UPE**)).

In TD 2022/11 Income tax: Division 7A: when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation'? (**TD 2022/11**), the Commissioner considers that the UPE arrangement is a form of financial accommodation under the extended definition of a loan in subsection 109D(3) *Income Tax Assessment Act* 1936 and that Division 7A applies. Subject to the other requirements of that provision (e.g. subject to the distributable surplus, etc.) where a complying Division 7A loan is not entered into, a deemed dividend is taken to have been paid by the private company to the trust. Accordingly, where a trustee of a trust enters into a complying Division 7A loan with a private company beneficiary to ensure the UPE is compliant with Division 7A, we submit that at this point the DDCR is not triggered. We recommend an example be included in the draft PCG to clarify the treatment of UPEs of a private company beneficiary and complying Division 7A loans.

We note that the Decision Impact Statement on *Bendel v Commissioner of Taxation* [2023] AATA 3074 states that until such time as "[…] *the appeal process is finalised, the Commissioner does not*

intend to revise the current ATO views relating to private company entitlements to trust income, as set out in [TD 2022/11]." Accordingly, and given that the Full Federal Court's reserved judgment has yet to be released (as at 22 November 2024), while the Commissioner continues to maintain the aforementioned view in TD 2022/11, we consider that, in the interests of taxpayer certainty, such an example should be included in the draft PCG.

Restructuring to repay Division 7A loans

Given that there is no anti-overlap provision to address the interaction between Division 7A and the DDCR, entities may seek to restructure to repay their Division 7A loans. Furthermore, with the increase in the benchmark interest rate for Division 7A loans to 8.27% for the income year ended 30 June 2024, many entities are likely to consider repaying their Division 7A loans independent of DDCR considerations.

We suggest that the ATO should not seek to apply the specific anti-avoidance rule in section 820-423D of the ITAA 1997 in such circumstances. Our view is that most entities within a private group would have had Division 7A loans in place in order to ensure that they were compliant with Division 7A as opposed to having these in place to artificially create debt deductions in Australia.

Accordingly, we recommend the draft PCG includes a restructuring example to clarify the treatment of the repayment of Division 7A loans that may be subject to the DDCR.