October 2024

# Tax Alert

## ATO draft practical compliance guidance: Debt deduction creation rules and restructures

### At a glance

- Draft Practical Compliance Guideline with comments due by 8 November 2024
- ATO compliance approach to reviewing taxpayers that have restructured their arrangements in response to the new debt deduction creation rules (DDCR)
- Specific DDCR anti-avoidance rule or the general anti-avoidance rule in Part IVA may be applied to cancel all or part of a tax benefit
- Four colour coded risk assessment framework for determining level of compliance scrutiny, based on low and high-risk factors
- General guidance and examples of operation of rules
- Further ATO guidance in relation to thin capitalisation planned
- How EY can help

The Australian Taxation Office (ATO) has issued a draft Practical Compliance Guideline (draft PCG 2024/D3[1], on 9 October 2024, here) to set out their compliance approach to reviewing taxpayers that have restructured their arrangements in response to the new debt deduction creation rules (DDCR)[2] (see our previous Global Tax Alert for a further summary of the rules here), including for the potential application of the general anti-avoidance rule in Part IVA of the Income Tax Assessment Act 1936 and the DDCR specific anti-avoidance rules.

The draft PCG outlines the ATO's compliance approach with a series of low and high-risk factors and a four colour coded risk assessment framework (white, yellow, green, and red zones) with varying levels of scrutiny for when they are likely to apply their resources to determine whether or not they will have cause to devote compliance resources to further examine restructures by taxpayers.

As part of this further examination the Commissioner of Taxation may seek to either apply the specific DDCR anti-avoidance rule or Part IVA to cancel all or part of a tax benefit where a taxpayer is considered to have restructured to avoid the application of the DDCR in a manner which preserves tax benefits going forward.

There are eight examples of low risk or high-risk restructures. Low-risk restructures include repaying the debt interest, disposing of foreign assets, and terminating swaps, provided they meet certain criteria. High-risk restructures involve arrangements where debt deductions are expected to be disallowed and similar deductions are claimed under restructured arrangements.

When finalised, the PCG will apply to restructures entered into on or after 22 June 2023 (the date the Act was introduced as a Bill into Parliament). The ATO may update their guidance as their engagement with affected taxpayers and their compliance activity increases throughout the implementation of the new thin capitalisation rules and DDCR.

The draft PCG is open for comments until 8 November 2024.

Given the necessary limited coverage of possible scenarios where the DDCR may apply and for which the ATO may or may not conduct compliance activities and also the lack of technical analysis and guidance, some taxpayers will need to consider how they will obtain comfort for whether the rules including the anti-avoidance rules apply, with options including to seek a private binding ruling from the ATO on their circumstances.

---

[1] PCG 2024/D3 - Restructures and the new thin capitalisation and debt deduction creation rules - ATO compliance approach

[2] Debt deduction creation rules in Subdivision 820-EAA of the Income Tax Assessment Act 1997 were introduced in *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024* (the Act)

## DDCR overview

The DDCR applies to income years commencing on or after 1 July 2024 to disallow debt (interest) deductions that arise from related party arrangements used to fund acquisitions of a CGT asset, or legal or equitable obligation, or payment/distribution to an associate pair.

The rules apply to "general class investors" and inward and outward investing financial entities (non-ADI). There are various exemptions from the rules including for entities with less than $2m debt deductions in a year (calculated on an associate inclusive basis) and for certain special entities. Notably, the thin capitalisation exclusion where 90% or more of the value of the entity's average assets are Australian assets does not apply for the DDCR.

The rules are complex and apply before the thin capitalisation rules. In particular, they may apply in respect of arrangements which occurred on or before 1 July 2024, as well as from that date.

The draft PCG is not a detailed tax ruling but it includes a summary of the DDCR rules and 11 examples of different scenarios where the DDCR may or may not apply in Schedule 1 of the draft PCG. There are 8 additional examples in Schedule 2 of the draft PCG which cover restructures. These examples are welcome given the absence of examples in the explanatory memorandum (EM) to the amending Bill.

Despite the fact that the summary and examples provide a useful background to circumstances in which a taxpayer may restructure their arrangements to seek to avoid the further application of the rules (see below), the draft PCG takes a conservative view that any restructuring that leads to the same amount of debt being in existence post restructuring, is likely high risk and deserves ATO resources devoted to examining it. One of the few exceptions to this is the repayment of bridging financing (see example 5). In our view, this is an overly restrictive view of the application of the rules as there may be circumstances that a commercial reorganization of existing structures giving rise to the same level of debt in Australia post reorganisation, may not necessarily enliven the anti-avoidance provisions covered in the draft PCG. We will be covering this in our response to the draft PCG consultation process.

There is further guidance on record keeping and apportionment of denied deductions but limited technical analysis, however it is possible that the ATO may provide other technical views on the rules in future guidance products.

The thin capitalisation rules and DDCR are complex and must also be factored into all new financing decisions of impacted entities. In addition, existing related party financing arrangements should be reviewed given there is no grandfathering of these arrangements.

## Specific DDCR anti-avoidance rule

The specific DDCR anti-avoidance provision is designed to address schemes seeking to avoid the debt creation rules. The anti-avoidance rule applies a "principal purpose" test rather than the higher threshold "dominant purpose" test and may readily impact any attempts to sidestep the application of the rules. This anti-avoidance provision may be problematic for those taxpayers who might seek to reorganize their affairs either before the commencement of the rules or thereafter.

Whilst the Supplementary EM to the amending Bill suggested that the specific anti-avoidance rule will not be applied where a taxpayer is "merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt creation rules", the actual legislation does not say that.

The draft PCG does not include any further technical analysis of this DDCR anti-avoidance rule nor for the technical application of the Part IVA provisions.

## Compliance approach

The draft PCG sets out the ATO's compliance approach to restructures by providing a risk assessment framework. Taxpayers can assess the risks associated with restructuring in response to the DDCR in accordance with this guidance.

A 'restructure' encompasses any restructure or refinancing, including any change, or reorganisation of group structure, business affairs or financial arrangements and includes any part of a broader restructure or a restructure that is part-way through and yet to be completed.

By following this guidance, taxpayers can understand the compliance risks associated with restructures being contemplated or already undertaken. If a restructure is low risk the ATO states that you can have confidence that they will not allocate resources to intensive examinations beyond verifying your self-assessment. Similarly, it provides certainty on areas of higher compliance risk that are likely to result in further and more intensive ATO examinations.

In addition, the ATO states if the DDCR needs to be considered for an arrangement, in the course of compliance activity they would ordinarily expect to allocate resources to ensure that the correct amount of debt deductions were disallowed.

### *Risk assessment framework*

The draft PCG sets out a risk assessment framework which provides guidance to entities on the level of compliance resources that will be devoted to the types of restructures and assists entities to assess their compliance risks.

The risk assessment framework includes white, yellow, green and red risk zones, and the different zones mean a different level of risk and a different risk rating, as follows:

| Risk zone | Risk level |
| --- | --- |
| White | Further risk assessment not required |
| Yellow | Compliance risk not assessed |
| Green | Low risk |
| Red | High risk |

An entity's risk rating will influence the ATO's engagements with the entity, including the intensity of assurance activities or whether the ATO is likely to engage with the entity to review the restructure. The ATO will generally prioritise resources and undertake more intensive investigations to address higher risk restructuring.

It is worth noting that as the ATO continue to administer the DDCR, they will revisit the risk-assessment framework, the zones and whether they accurately reflect the risks associated with each restructure.

The draft PCG gives information on each risk zone, when an entity is in a particular zone and provides examples of both low-risk and high-risk structures.

*The 'white zone'*

The 'white zone' means that further risk assessment is not required. An entity is in the 'white zone' where they have entered into a settlement agreement with the ATO since the enactment of the DDCR on 8 April 2024 or are a party to a court proceeding which involves a decision on the Australian tax outcomes of the entity's arrangement under the DDCR.

An entity's restructure will be in the white zone as long as there has not been a material change in the arrangement since the time of the agreement or court decision.

The ATO do not anticipate that many entities will have restructures in the white zone at this early stage of administration of the DDCR, however, if an entity is in the 'white zone', the ATO will not have cause to apply compliance resources beyond simply verifying that the entity has met one of the two conditions for the white zone.

*The 'yellow zone'*

The 'yellow zone' means that the compliance risk is not assessed, and the entity has undertaken one or more restructures in response to the DDCR, that do not fall into the green or red zones. The ATO may engage with the entity to understand compliance risks of the restructure.

*The 'green zone'*

The green zone means that the restructure is low risk, and the ATO will generally only devote compliance resources to tax risks in scope of the draft PCG to obtain comfort and verify the entity's self-assessment.

An entity's restructure is in the 'green zone' if the restructure is covered by the low-risk examples in Schedule 2 of the draft PCG, exhibit the features of low risk restructures (outlined below) and where the restructure is otherwise commercial. An entity's restructure is also in the green zone if the ATO have conducted a review or audit of the re-structure and provided the entity with a 'low-risk' rating and there has not been a material change in the arrangement which informed the basis of the rating.

*The 'red zone'*

The 'red zone' means that the restructure is high risk, and these restructures are expected to attract intensive compliance action.

An entity's restructure is in the 'red zone' if the restructure is covered by the high-risk examples in Schedule 2 of the draft PCG, or the ATO has provided the entity with a 'high risk' rating (or low assurance under a Justified Trust review).

The 'red zone' is a reflection of the features the ATO consider indicate greater risk, and if an entity's restructure is in the red zone, the ATO will prioritise resources to review the arrangement which may involve commencing a review or an audit. However, it is not a presumption that the DDCR special anti-avoidance provision or the general anti-avoidance provision in Part IVA of the ITAA 1936 will necessarily apply to the arrangement.

## Low-risk restructures

The draft PCG notes that the following factors must be present for a restructure to be low risk:

- Debt deductions disallowed by the DDCR prior to the restructure have been accurately calculated
- Prior to the restructure, the arrangements would not have attracted the application of Part IVA of the ITAA 1936
- The restructure occurs in a straightforward manner having regard to the circumstances without any associated contrivance or artificiality and is on arm's length terms
- The arrangement following the restructure will not attract the application of Part IVA of the ITAA 1936.

All of these features must be present for the restructure to be classified as low risk and if any of the features are not present, the restructure will not be regarded as low risk.

Where a restructure is only low risk, the ATO will generally only allocate compliance resources to obtain comfort and verify the self-assessment.

The ATO expect that the lowest risk re-structures generally involve the repayment of all related party debt in relation to covered transactions without any additional debt being issued or acquired.

Some examples of low-risk restructures include:

- Example 12 – repaying debt interest using retained earnings and dividends
- Example 13 – repaying bridging finance prior to sourcing additional external financing
- Example 14 – disposing of foreign subsidiary so they are no longer classified as a general class investor
- Example 15 – repaying debt interest by the injection of equity, terminating swaps and recapitalising a subsidiary
- Example 16 – repaying debt interest with the issuance of additional equity interests
- Example 17 – repaying cash pooling that was used in relation to the acquisition of CGT assets from associate pairs and payment of dividends and royalties to associate pairs.

### *High-risk restructures*

The draft PCG notes that higher risk arrangements may include round robin financing, contended change in 'use' of debt under other related party arrangements, or a contrived arrangement to choose and use the third-party debt test, to prevent the DDCR from applying.

Examples of high-risk arrangements include:

- Example 18 – an entity enters into a debt factoring arrangement of the same value of the initial debt interest, contending there is a change in use of the debt and change in the character of debt deductions incurred.
- Example 19 – an entity enters into a third-party debt arrangement to replace related party debt with third party debt.

## Other guidance

### *Record keeping*

The draft PCG includes comments on the ATO's expectations for record keeping and obtaining sufficient information for tracing the use of related party debt to determine if an arrangement is caught by the rules.

The ATO acknowledges challenges in obtaining records for historical transactions but expects taxpayers to provide sufficient documentation for compliance. A list of example documents and other information which may assist taxpayers to demonstrate whether the DDCR applies to debt deductions in relation to historical transactions is provided.

The ATO expects that contemporaneous documentation and associated analysis on the operation of the DDCR (including evidentiary support for tracing the use of funds) would be kept for transactions since the enactment of the law and states that a deduction should not be claimed unless sufficient information is available to support a conclusion that the DDCR does not apply.

### *Tracing of funds and apportionment*

The draft PCG makes it clear that the onus of proof remains with the taxpayer, even for historical transactions that span into the early past, with no time limit applying. Where there is mixed use of debt funding the ATO considers that tracing should be the method used to determine the disallowed debt deduction wherever possible. The taxpayer will need to prove a tracing of funds if it wishes to demonstrate that "tainted DDCR debt" has been since repaid. The draft PCG provides examples of some of the records that a taxpayer will need to produce but ultimately the onus is on the taxpayer to demonstrate its case in terms of specific fund flows.

However, apportionment may be appropriate where it is not possible to trace, such as where funds from various sources that were used for different purposes are combined into a single debt interest.

The ATO considers a fair and reasonable apportionment method to be one where the debt deductions under a facility are disallowed in the same proportion of the "DDCR debt" to total debt in circumstances where related party debt that funded covered transactions is refinanced into a single related party debt facility that also includes debt in relation to other purposes. This includes any repayments of principal and capitalisation of interest. The ATO would apply compliance resources to investigate apportionment approaches based on hypothetical circumstances or allocating repayments first to debt which may be subject to the DDCR without contemporaneous documentation to support that allocation.

### *Reportable tax position and other disclosures*

The draft PCG flags that disclosure of a taxpayer's risk rating applying the risk assessment framework may be added to the reportable tax position (RTP) schedule.

We note that the International Dealings Schedule (IDS) for the 2024 year includes a new question which requires an entity to disclose where they have restructured or replaced an arrangement during the income year which would have satisfied the DDCR, if it was still in place on or after 1 July 2024. The ATO stated that the purpose of this question is to identify risks associated with restructuring in anticipation of the DDCR having effect.

### *Draft PCG examples where DDCR may or may not apply*

The draft PCG includes the following examples of the potential application of the DDCR:

Scenarios where DDCR should not apply:

- Example 1 – timing and the 'associate pairs' conditions (asset acquisition case)
- Example 2 – funding capital expenditure only with related party debt (payment distribution case)
- Example 3 – funding working capital and dividends with related party debt (payment/distribution case)
- Example 4 – cash pooling
- Example 5 – bridging finance (asset acquisition case)
- Example 7 – related party transactions to recharge outcomes arising from swaps (asset acquisition case).

Scenarios where DDCR would apply:

- Example 6 – related party financing of related party acquisition (asset acquisition case)
- Example 8 – debt deductions in relation to an acquisition from an associate pair (asset acquisition case)
- Example 9 – acquisition from a related trust (asset acquisition case)
- Example 10 – loan funding distribution by trustee (payment/distribution case)
- Example 11 – related party lending between multinational subsidiaries (asset acquisition case).

## Other planned ATO guidance

It had been expected that the draft PCG would also cover the ATO's concerns with restructuring in response to the new thin capitalisation rules which apply for income years commencing on or after 1 July 2023. However, this guidance will now be added to the PCG when the ATO publishes its planned draft public ruling on the third-party debt test, which is under development and expected soon.

The ATO has also committed to provide updated guidance on how the transfer pricing rules will apply to further limit debt deductions following thin capitalisation changes which now require taxpayers to test both the appropriate amount of debt and the applicable interest rate before applying the fixed ratio or group ratio tests (to update the existing PCG 2017/4).

## How EY can help

- EY can assist you assess the risk calibration of the application of the DDCR to any existing structures.
- We can then assist you in determining what options there are for mitigating such risk including whether those options fall with the low vs high risk framework of the draft PCG.
- We can also assist with approaching the ATO to seek a ruling or other form of guidance in respect of your situation including any proposed future transactions being contemplated.
- We can also assist in assessing the interaction between the DDCRs and the thin capitalisation rules, especially the third-party debt test which overlaps with the DDCR.

## For more information please contact your usual EY advisor or:


**Sydney**
Alf Capito
Tel: +61 2 8295 6473
alf.capito@au.ey.com

Lachlan Coban
Tel: +61 2 9248 4496
lachlan.cobon@au.ey.com

Sean Monahan
Tel: +61 2 8295 6226
sean.monahan@au.ey.com

Matt Weerden
Tel: +61 2 8295 6788
matt.weerden@au.ey.com

Daryl Choo
Tel: +61 2 9248 4472
daryl.choo@au.ey.com

David Burns
Tel: +61 2 9248 5059
david.burns@au.ey.com

Simon Jenner
Tel: +61 2 8295 6367
simon.jenner@au.ey.com

Danielle Donovan
Tel: +61 2 8295 6333
danielle.donovan@au.ey.com

**Brisbane**
Reid Zulpo
Tel: +61 7 3243 3772
reid.zulpo@au.ey.com

Rebecca Lapraik
Tel: +61 7 3011 3388
rebecca.lapraik@au.ey.com

Michael Hennessey
Tel: + 61 7 3243 3691
michael.hennessey@au.ey.com

Michael Chang
Tel: + 61 7 3011 3126
michael.chang@au.ey.com

**Adelaide**
Sean M van der Linden
Tel: +61 8 8417 1688
sean.van.der.linden@au.ey.com

**Melbourne**
Richard Goodwin
Tel: +61 3 9288 8545
richard.goodwin@au.ey.com

Andrew Woollard
Tel: +61 3 8650 7511
andrew.woollard@au.ey.com

Tony Merlo
Tel: +61 3 8575 6412
tony.merlo@au.ey.com

Liz Cullinan
Tel: +61 3 8650 7938
liz.cullinan@au.ey.com

Peter Janetzki
Tel: +61 3 8650 7525
peter.janetzki@au.ey.com

Sarah Diss
Tel: +61 3 9288 8230
sarah.diss@au.ey.com

Edward Ng
Tel: +61 3 9655 2672
edward.ng@au.ey.com

Graeme Friend
Tel: +61 3 9288 8236
graeme.friend@au.ey.com

**Perth**
Andrew Nelson
Tel: +61 8 9429 2257
andrew.nelson@au.ey.com

Mathew Chamberlain
Tel: +61 8 9429 2368
mathew.chamberlain@au.ey.com

Joe Lawson
Tel: +61 8 9429 2489
joe.lawson@au.ey.com

Caroline Walker
Tel: +61 8 9217 1897
caroline.walker@au.ey.com


## EY | Building a better working world

**EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.**

**Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.**

**Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.**

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data, and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

**About EYs Tax services**
Your business will only succeed if you build it on a strong foundation and grow it in a sustainable way. At EY, we believe that managing your tax obligations responsibly and proactively can make a critical difference. Our global teams of talented people bring you technical knowledge, business experience and consistency, all built on our unwavering commitment to quality service – wherever you are and whatever tax services you need.

We create highly networked teams that can advise on planning, compliance and reporting and help you maintain constructive tax authority relationships – wherever you operate. Our technical networks across the globe can work with you to reduce inefficiencies, mitigate risk and improve opportunity. Our 50,000 tax professionals, in more than 150 countries, are committed to giving you the quality, consistency and customization you need to support your tax function.

For more information, please visit www.ey.com/au


© 2024 Ernst & Young, Australia.
All Rights Reserved.

Liability limited by a scheme approved under Professional Standards Legislation.



SCORE NO: 008645-24-AUNZ
ED None



This communication provides general information which is current at the time of production. The information contained in this communication does not constitute advice and should not be relied on as such. Professional advice should be sought prior to any action being taken in reliance on any of the information. Ernst & Young disclaims all responsibility and liability (including, without limitation, for any direct or indirect or consequential costs, loss or damage or loss of profits) arising from anything done or omitted to be done by any party in reliance, whether wholly or partially, on any of the information. Any party that relies on the information does so at its own risk.