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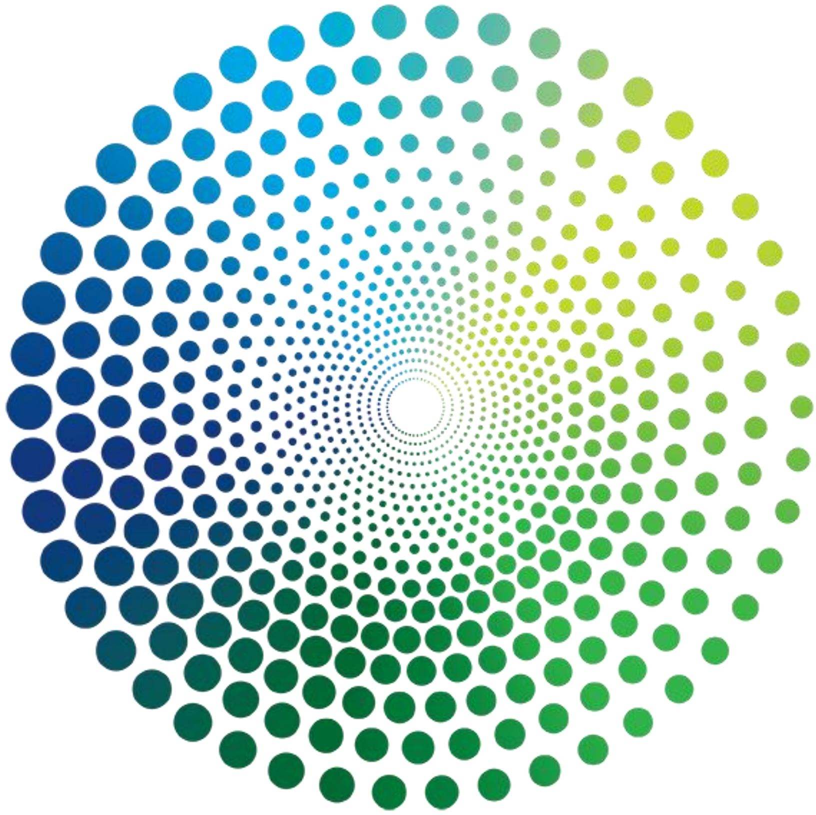

Tax Insights

Draft guidance issued on compliance approach to restructures under the DDCR

On 9 October 2024, the Australian Taxation Office (ATO) released long-awaited draft guidance in the form of a draft practical compliance guideline (PCG) titled PCG 2024/D3 Restructures and the new thin capitalisation and debt deduction creation rules.

Given the thin capitalisation amendments apply to years commencing on or after 1 July 2023 and the debt deduction creation rules (DDCR) apply to years commencing on or after 1 July 2024, this draft guidance has been much anticipated.

As well as setting out some general guidance on application of the DDCR, the guideline provides a risk assessment framework on the potential application of the general anti-avoidance rules (part IVA) and the DDCR specific anti-avoidance rule (SAAR) in section 820-423D to restructures in response to the new rules. Like other PCGs, taxpayers may be required to report their risk rating, for example, where they are required to lodge a reportable tax position schedule.

The term "restructure" is defined in the PCG to encompass any restructure or refinance, including 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.

When finalised, this guideline applies to restructures entered into on or after 22 June 2023 (the date the act was introduced into parliament). Comments on the draft guideline are due by 8 November 2024.

Structure of the PCG

The guideline is structured as follows:

- Main body: Sets out the general principles of the ATO's risk approach and application of compliance resources.
- Schedule 1: Covers examples where the DDCR may need to be considered.
- Schedule 2: Covers the compliance risks arising from restructures in response to the DDCR.
- Schedule 3 (not yet available): Will cover the compliance risks arising from restructures in response to the updated thin capitalisation rules. The ATO advises that schedule 3 will be added concurrently with the publication of the draft public ruling on the third-party debt test (TPDT), expected at the end of 2024.

Debt deduction creation rules

In appendix 1, the PCG provides some welcome guidance on:

- Examples where the DDCR may need to be considered; and
- Records and evidence relevant to such considerations, including tracing and apportionment of funds.

The majority of the examples in appendix 1 illustrate a straightforward application of the law. However, several examples are of interest in either confirming the ATO's application of the law or illustrating further uncertainty.

- Example 1 confirms that the DDCR should not apply where the parties to a transaction are not "associate pairs" at the time of an acquisition, even where the parties become associate pairs thereafter (for example by becoming partners in a general law or tax law partnership for the development of land for residential purposes).
- Example 4 provides guidance around cash pooling arrangements, and broadly confirms that where a taxpayer's balance fluctuates between negative and positive over a year, and such funds are used to acquire capital gains tax assets from associate pairs and to fund dividends, royalties, and returns of capital to associate pairs, compliance resources may be allocated to verify the correct application of the DDCR for the year. Given the tracing difficulties of cash pool arrangements, taxpayers may want to rethink the costs and benefits of including Australian entities in such arrangements going forward.
- Both examples 9 and 10 make it clear that complying division 7A loans may be subject to the DDCR, as highlighted by web guidance. Although expected, this may be a disappointing result for large private groups particularly where the loans are wholly domestic in nature and no revenue is at risk due to the associate pair lending.
- Example 2 sets out a group structure in which Aus Sub Co 1 operates a mine in Australia, and regularly pays dividends to its Australian holding company (Aus Co) and ultimately up to a foreign holding company. Aus Sub Co 1 does not have any borrowings. Aus Co has another wholly owned subsidiary, Aus Sub Co 2 which acquires a separate mining lease, from an unrelated third party (Mine 2). To fund the development of Mine 2, Aus Co issues associate pair debt to its foreign holding company which is on-lent to Aus Sub Co 2 on back-to-back terms. The PCG states that Aus Co would not need to consider the application of the DDCR **while Mine 2 is in development**, as Aus Co's borrowings are not used to fund or facilitate the funding of any dividends. Including the comment highlighted in bold leaves open the question of how the DDCR operates following completion of the development.

In practice, taxpayers will need to consider many facts and circumstances when considering the long-term application of the DDCR to historical debt arrangements, particularly where a dynamic business environment requires ongoing changes to structures and funding, necessitating cash flow agility.

Documentation and apportionment

The DDCR requires taxpayers and their associate pairs to trace the use of relevant debt funding transactions, including both direct and indirect transactions.

Historical transactions

While the ATO has recognised that it can be challenging to obtain relevant documents and information to evidence or substantiate use of associate pair debt funding for historical transactions, it nonetheless reiterates that the onus is on the taxpayer to prove that the DDCR does not apply.

Despite stakeholder requests that a temporal limit (such as five years prior to enactment) be placed on historical transactions, the ATO does not consider such an approach to be available under law or appropriate.

Transactions since enactment

Importantly, the ATO notes that since enactment of the DDCR, record-keeping best practices have changed. Taxpayers, in conjunction with associate pairs, are expected to keep contemporaneous documentation and associated analysis on the operation of the DDCR (including evidentiary support for tracing the use of funds), for both direct and indirect arrangements.

A deduction should not be claimed unless sufficient information is available to support a conclusion that the DDCR does not apply.

In practice, the associate pair threshold can be quite low, and there may be no way to compel an associate to provide relevant information.

Tracing and apportionment of funds

The ATO considers that tracing is a factual exercise and should be the method used to determine the disallowed debt deduction under subsection 820-423A(1) wherever possible. No acceptable methodology or practical recommendations are provided.

However, fair and reasonable 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 has rejected outright methodologies that either:

- Rely on a hypothesis of what may instead have occurred had the DDCR been in operation at the time; or
- Allocate historical principal repayments to any debt that may give rise to disallowance under the DDCR, and allocate principal repayments to other debt after the DDCR debt portion has first been treated as repaid without contemporaneous documentation to support that allocation.

Risk assessment framework

The PCG's risk assessment framework is designed to explain how to assess the compliance risks of restructuring with respect to the changes. The ATO has set out four risk zones as follows:

Table 1: Risk assessment framework

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

Interestingly, the ATO notes that as it continues to implement the DDCR, it expects to revisit these zones. Consultation will be undertaken on any proposed material changes.

White zone

Taxpayers will be in the white zone if all of their restructures in response to the DDCR are addressed in a relevant settlement agreement with the ATO or court decision involving the taxpayer. Restructures 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 decision.

If a restructure is in the white zone, the ATO will not have cause to apply compliance resources beyond verifying that taxpayers can substantiate that the conditions for the white zone have been met.

Green zone

Taxpayers are in the green zone if all of their restructures in response to the DDCR are in the following categories:

- The restructure in response to the DDCR in the income year is:
    - Covered by the low-risk examples in schedule 2; and
    - Exhibit the features set out in paragraph 166 of the PCG (set out below); or
- The ATO has conducted a review or audit of the restructure and
    - Provided a "low-risk" rating (or "high assurance" under a justified trust review); and
    - There has not been a material change in the arrangement which informed the basis of the risk or assurance rating in the review or audit.

If a restructure is in the green zone, the ATO will generally only devote compliance resources to obtain comfort and verify the self-assessment.

Paragraph 166 states that restructures are only low risk where the arrangements are otherwise commercial. The following features must all 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;
- 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; and
- The arrangement following the restructure will not attract the application of part IVA.

Red zone

Taxpayers will be in the red zone if any of their restructures in response to the DDCR are in the following categories:

- The restructure (including any part of a restructure) in response to the DDCR in the income year is covered by a high-risk example in schedule 2; or
- The ATO has conducted a review or audit of the restructure and provided a "high-risk" rating (or "low assurance" under a justified trust review).

If a restructure is in the red zone, the ATO will prioritise resources to review the arrangement and may commence a review or audit. While a red zone indicates the ATO's view of greater risk; it is not a presumption that the SAAR or part IVA will necessarily apply.

For example, higher risk arrangements may include round robin financing, contended change in "use" of debt under other associate pair arrangements, or a contrived arrangement to choose and use the TPDT with the purported effect of preventing the DDCR from applying.

Yellow zone

Taxpayers will be in the yellow zone where they have undertaken one or more restructures (including any part of a restructure) in response to the DDCR in the income year that are not in the green or red zones (i.e., restructures that are not covered by examples in schedule 2).

If a restructure is in the yellow zone, the ATO may engage with the taxpayer to understand the compliance risks of the restructure.

Examples of high-risk and low-risk arrangements

The majority of the low-risk scenarios set out in schedule 2 are examples of conservative restructures which generally involve repayment of associate pair loans or swaps such that there are no longer any relevant debt deductions.

The repayment of an associate pair loan funded by issuing new equity or from profits is generally seen as low risk (examples 15, 16, and 17), however a repayment funded by third party debt can be "high-risk" if it is perceived as debt dumping of offshore third party debt into Australia (contrast the third party refinancing examples 13 and 19 which are at each end of the risk spectrum).

Taxpayers intending to clean up offshore dormant structures can be comforted by example 14, in which the disposal of a dormant foreign entity is considered low risk, even where this results in the Australian entity ceasing to be a general class investor.

We note that the prospect of replacing interest bearing associate pair debt with non-interest-bearing associate pair debt as suggested in example 17 could be problematic from an (offshore) transfer pricing perspective, even if the restructure is seen as a low-risk restructure for DDCR purposes.

Deloitte Australia comment

As mentioned, the draft PCG is subject to consultation and we look forward to engaging with the ATO with the aim of clarifying uncertainty and finalising the PCG.

We expect that many taxpayer restructures, which do not completely eliminate associate pair debt or are not refinanced using share capital, will be categorised in the yellow zone.

The combined effect of the DDCR (with the requisite high expectations regarding documentation) overlaid with the expanded transfer pricing rules and thin capitalisation amendments will make many Australian associate pair loans particularly problematic for multinational groups.

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