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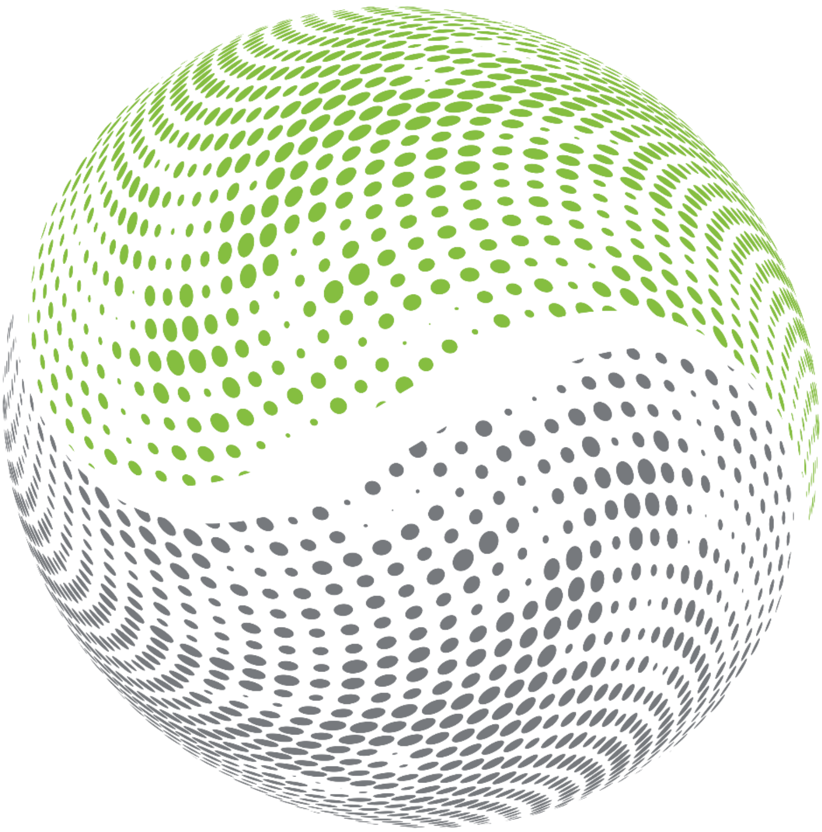
Australia 2025/19



Tax Insights

ATO releases final guidance on third party debt test and related restructures

On 1 October 2025, the Australian Taxation Office (ATO) released the following final guidance:

- *TR 2025/2 Income tax: aspects of the third-party debt test in Subdivision 820-EAB of the Income Tax Assessment Act 1997*, as well as a ruling compendium providing responses to issues raised during consultation. The final ruling provides interpretative guidance in respect of the third party debt conditions (TPD conditions), being the strict requirements a debt interest issued by an entity must meet in order to satisfy the new third party debt test (TPDT) under the new interest limitation rules; and
- An update to *PCG 2025/2: Restructures and the thin capitalisation and debt deduction creation rules—ATO compliance approach* as well as a practical compliance guideline (PCG) compendium providing responses to issues raised during consultation. This guideline was last published on 20 August 2025, with schedules 1, 2, and 4. This update amends the guideline to include the finalised schedule 3 which outlines the ATO's targeted compliance approach in relation to certain matters arising under the TPDT.

Further finalised guidance is expected in late 2025 in the form of a final PCG titled *Factors to consider when determining the amount of your cross-border related party finance arrangement* in relation to the determination of the arm's length amount of debt for transfer pricing purposes (subdivision 815-B of the Income Tax Assessment Act 1997). This PCG will also outline specific features of financing arrangements and transfer pricing analysis which the ATO would view as being of concern.

Overview

In broad terms, the TPDT is intended to facilitate interest deductions attributable to third party loans that are used to fund Australian operations, while preventing entities from using offshore assets to inflate borrowing capacity. Access to the TPDT requires an election to be made and for the relevant loan to meet a strict set of conditions.

The final ruling addresses a number of the concerns that had been raised through submissions, including the uncertainties in a range of common scenarios in relation to the ATO earlier draft interpretation of the terms "Australian assets" and "commercial activities in connection with Australia." However, some significant issues remain, including in relation to:

- Whether membership interests (e.g., shares and units) are Australian assets in a situation where there are any underlying non-Australian assets, relevant to whether the borrower can satisfy the recourse requirement and the use of proceeds requirement (refer below); and

- The use of proceeds from issuing a debt interest to fund distributions continues to be seen as not constituting commercial activities in connection with Australia.

The ATO includes new compliance approaches in the final PCG facilitating restructuring or remediation of the above types of arrangements.

A range of matters raised through the consultation process have not been addressed in the final ruling, with the ATO noting that the ruling is limited in scope and is not intended to cover all factual circumstances. In particular, various submissions sought interpretative guidance in relation to:

- The breadth of "debt deductions" now captured under the thin capitalisation rules;
- The operation of the conduit financing rules (e.g., on-lending on back-to-back terms using a FinCo third party debt issuer);
- The development concession; or
- Various issues relating to swaps.

As the ATO's views on the issues covered by TR 2025/2 are now finalised, to the extent unintended consequences arise, these may need to be addressed by legislative amendment or through the judicial system. Included in the bill enacting the new thin capitalisation rules was a requirement that an independent review of the operation of the amendments must be conducted no later than 1 February 2026. The period for issuing a report is then within 17 months of commencement of the review (i.e., around 30 June 2027).

Background to the third party debt test

Broadly, the interest limitation rules (or thin capitalisation regime) apply to general class investors and are operative for years of income starting on or after 1 July 2023. There are three potential tests available to general class investors, being the:

- Fixed ratio test (FRT), the default test based on 30% of tax EBITDA (earnings before interest, taxes, depreciation, and amortisation);
- Group ratio test (GRT) (where a choice is made); and
- TPDT (where a choice is made or deemed to be made).

A general class investor or financial investor (non-authorised deposit-taking institution (ADI)) that is an Australian entity can choose to apply the TPDT for an income year. Broadly, the TPDT is intended to facilitate debt deductions attributable to genuine third party debt which is used to fund Australian operations where the lender has recourse (generally) only to assets of the Australian operations. Conversely, deductions for any debt or debt interests that do not meet the TPD conditions will be entirely disallowed if a TPDT choice applies.

Broadly, the test is one-in all-in, so that all members of a tax "obligor group" that are associate entities of the borrower (broadly, based on a 20% ownership threshold) or parties to a cross-staple arrangement are deemed to have chosen to apply the TPDT if a relevant entity makes the choice (including a deemed choice).

The TPDT comprises:

- A base test for third party debt provided directly to the Australian entity borrower; and
- Conduit financing modifications for third party debt provided to a conduit financer that is on-lent to related parties on (broadly) the same terms.

The TPDT operates to determine an entity's "third party earnings limit" for an income year, which is the sum of each debt deduction of the entity for the income year that is attributable to a debt interest issued by the entity that satisfies the TPD conditions in relation to the income year.

A debt interest issued by an entity satisfies the TPD conditions if:

- The entity is an Australian entity;
- The entity issued the debt interest to an entity that is not an associate entity of the entity (broadly, based on a 20% ownership threshold);
- The debt interest is not held at any time in the income year by an entity that is an associate entity of the entity (broadly, based on a 20% ownership threshold);
- Disregarding recourse to minor or insignificant assets, the holder of the debt interest has **recourse for payment of the debt only to Australian assets held by the entity, Australian assets held by an Australian entity in the tax obligor group, or membership interests in the borrower** (unless the borrower has a legal or equitable interest, directly or indirectly, in a non-Australian asset). However, recourse to assets that are rights under or in relation to a guarantee, security, or other form of credit support (credit support rights) are prohibited, unless specified exclusions apply; and
- The entity **uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia**, excluding any business carried on at or through an offshore permanent establishment and investments in associate entity debt, controlled foreign entity debt, or controlled foreign entity equity.

TR 2025/2: Aspects of the third party debt test

The focus of the ruling is on certain TPD conditions under the base test. The conduit financing modifications are not covered in the ruling. Some of the key changes between the draft and final rulings are set out below.

Recourse for payment of the debt

The ATO clarifies that where the issuer or a member of the tax obligor group holds assets that are rights against another entity (i.e., credit support rights), or membership interests in another entity, those rights or membership interests themselves are the relevant assets, and that there is no requirement to "look through" those rights or membership interests to underlying assets held directly or indirectly by the other entity, for the purpose of determining the assets to which the holder of the debt interest has recourse.

Minor or insignificant exception

Any recourse to "minor or insignificant" assets is disregarded when determining the assets to which the holder of the debt interest has recourse.

The ATO notes that "credit support rights are unlikely to ever be minor or insignificant assets" but does not provide any basis for this view nor how the value of credit support should be determined in this context. Potentially the comment is intended to pre-empt any argument that contingencies associated with a credit support right may justify treating the right as a minor or insignificant asset. In that regard, the ATO is also of the view that the "actual or hypothetical" impact of an ineligible asset on the quantum of debt is not determinative of whether that asset is minor or significant. Therefore, if it is correct that contingent rights of the borrower such as pursuant to an equity commitment deed, letters of credit, or performance bonds may constitute credit support to which a lender has recourse for payment of the debt, then it appears unlikely that the ATO will accept that a lender's recourse to those rights may be disregarded on the basis they are minor or insignificant. This highlights the need for the ATO to provide further guidance regarding whether such contingent rights would actually qualify as credit support noting that such rights are generally inaccessible to a lender for repayment of the debt unless the contingency (e.g., a failure to perform) has been satisfied.

The ATO also maintains the view that the "minor or insignificant" exception covers only assets of minimal or nominal value, rejecting the view that the actual or hypothetical impact of any ineligible assets on the quantum or terms of the debt interest is relevant in assessing whether those assets are minor or insignificant.

Recourse only to Australian assets

A critical TPD condition is that the lender has recourse for payment of the debt only to certain "Australian assets," in order to prevent entities from using offshore assets to inflate borrowing capacity.

The ATO's interpretation of the term "Australian assets" has received a significant overhaul and now involves consideration of the commercial and economic context, the nature of the asset, and its connection or relationship to Australia, bearing in mind the purpose of the rules. In a number of places, the ATO uses the term "asset having a substantial connection to Australia" as the appropriate threshold and references to "used exclusively in Australia" have been removed.

Factors that may point towards an asset having a substantial connection to Australia include:

- The asset is physically located in Australia;
- The asset is used in Australia;
- The asset is used by, or benefits, an Australian entity (provided it is not attributable to the entity's overseas permanent establishments or offshore commercial activities);
- The asset is governed by, or originates from, an Australian legal framework;
- The asset is used for the purpose of producing Australian-sourced assessable income; and
- The asset has no, or only a limited or remote connection to another jurisdiction (provided it is substantially connected to Australia).

There is also specific discussion of factors that may be relevant to intangible assets, such as the extent to which the asset is used in a business carried on in Australia. Factors relevant to whether these assets are Australian assets may include:

- The location of the contracting parties and whether or not they are Australian entities;
- The jurisdiction governing the relevant assets or contracts;
- The extent to which the asset is used or held in a business carried on in Australia, or conversely, one not carried on in Australia;
- The situs of the asset for the purpose of succession, estate law, or private international law; and
- Whether the intangible asset is supported by assets of the counterparty that are themselves Australian assets—for example, where any payments or obligations under the asset are expected to be met from Australian assets.

The factors outlined in the ruling are not intended to be exhaustive and the weight of each factor needs to be determined based on the particular circumstances.

Importantly, a more than "tenuous or remote" connection to a foreign jurisdiction is no longer seen as fatal, although any such connection needs to be considered along with other factors. While a bright line test would have provided more certainty, the factors seem sensible and accommodate a range of situations where assets are used in Australian operations.

When it comes to shares and units, the ATO now sets out that a full look-through to underlying assets is required, and if the entity holds underlying non-Australian assets that are more than minor or insignificant (based on the ATO view, meaning having more than a minimal or nominal value), then the shares or units in the entity will not be Australian assets (refer paragraphs 95 and 96, and new example 12). In this regard, where a borrower holds shares or units in non-controlled entities or portfolio investments it may be difficult (or impossible) to determine whether the shares or units are Australian assets.

Under the TPDT the lender is permitted to have recourse for payment to Australian assets being membership interests in the borrower "unless the [borrower] has a legal or equitable interest, whether directly or indirectly, in an asset that is not an Australian asset." In response to submissions, the ATO has clarified that it **does not** consider that a "minor or insignificant" exclusion can be read into this rule and therefore where the borrower (directly or indirectly) holds shares or units in an entity that has **any** non-Australian assets, the recourse requirement may not be satisfied in respect of the membership interests in the borrower (see new example 13). Perversely, if the entity that owned the membership interests in the borrower also provides the lender with recourse to other assets, it would be a member or the tax obligor group and the minor or insignificant exclusion would be available.

Use of proceeds requirement - "all, or substantially all"

Another TPD condition is that, in relation to the relevant income year, the borrower uses "all, or substantially all," of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia that do not include any business carried on by the entity at or through its overseas permanent establishments, and the holding by the entity of any associate entity debt, controlled foreign entity debt, or controlled foreign entity equity.

The final ruling no longer equates "substantially all" with "minimal or nominal," rather providing that "substantially all" is synonymous with "nearly all" or "almost all." While no further guidance is provided in this regard, this might be seen to permit consideration of the relative value of the impermissible use, as compared with the amount of the loan.

While the draft ruling suggested that the term "substantially all" would generally accommodate borrowing fees or establishment fees (implying incurring such fees did constitute "commercial activities"), the final ruling has removed this reference, presumably because such fees now more readily meet the revised interpretation of the term "commercial activities," as discussed below.

Use of proceeds requirement—commercial activities in connection with Australia

The ATO now confirms that assessing compliance with the use of proceeds requirement requires tracing the use of the funds. The concept of tracing the use of funds introduces a range of practical and evidentiary issues, as highlighted in relation to the requirement to trace the use of funds in the context of the "debt deduction creation rules."

The interpretation of "commercial activities" in Draft TR 2024/D3 has been updated to remove the exclusion for so-called "capital management activities," and the final ruling sets out that commercial activities in connection with Australia include:

- Activities undertaken in the course of the entity's business, provided they are connected with Australia—for example, acquiring or constructing plant, equipment, infrastructure, or real property located in Australia and used in the Australian business;

- Ancillary and supporting activities directly related to these activities, again provided they are connected with Australia—for example, funding Australian overheads, payroll, insurance, or legal and tax advice; and

- Refinancing debt that was used to fund commercial activities in connection with Australia, provided the nexus to those activities is maintained.

The ATO considers that "commercial activities in connection with Australia" do not include:

- Any business carried on by the entity at or through its overseas permanent establishments;
- The holding by the entity of any associate entity debt, controlled foreign entity debt, or controlled foreign entity equity;
- The acquisition, directly or indirectly, of assets that are not Australian assets; and
- The payment or distribution of dividends or capital returns—these are appropriations of profit or equity.

As indicated above, the ATO still considers that the payment or distribution of dividends or capital returns are not commercial activities in connection with Australia. One criticism of this interpretation is that it creates an arbitrary distinction between domestically controlled groups, that are generally able to deduct interest where higher levels of third party debt are introduced, as supported by their Australian assets and operations, and foreign controlled groups that may suffer partial (or full) denial of interest deductions in identical circumstances. Other TPD conditions prevent entities from using offshore assets to inflate borrowing capacity, and the ATO's restrictive interpretation of "commercial activities" does nothing to advance this policy objective, but rather seems to create a new type of debt deduction creation rule (noting that the actual debt deduction creation rules do not generally apply to third party debt).

Credit support rights

Under the TPD conditions, recourse to Australian assets that are rights under or in relation to a guarantee, security, or other form of credit support (credit support rights) is generally prohibited. The ATO considers that, broadly, rights that operate to reduce the risk of default by the issuer in respect of the debt interest will generally be covered.

However, the rules allow a credit support right to be disregarded where it is any of the following (except where it provides recourse directly or indirectly against a foreign associate entity (broadly, based on a 50% ownership threshold)):

- A right that provides recourse, directly or indirectly, only to one or more Australian assets (other than another credit support right that is not disregarded) that satisfy the recourse requirements (see new example 19);

- A right that is provided by a non-associate entity (broadly, based on a 20% ownership threshold). The final ruling provides the following examples:

    - Bank guarantee provided by customers under long-term electricity transmission contracts (example 20); and
    - Parent guarantee provided by a lessee (example 21);

- A right that relates wholly to the development of land situated in Australia (including an interest in land) or movable property that is relevant to the use of the land and will remain on the land for most of its useful life (e.g., a renewable energy generating asset that is movable property situated on Australian land as outlined in the explanatory memorandum). The final ruling provides the example of a cost overrun support deed entered into by an investor with the borrower (example 22); or

- A right that relates wholly to the development of offshore renewable energy infrastructure (within the meaning of the Offshore Electricity Infrastructure Act 2021) situated in a declared area (including directly related infrastructure of that kind).

For new example 19, it is worth highlighting that the loan would actually not meet the TPD conditions as it appears that the offshore investors are associate entities (and therefore members of the tax obligor group), and on the basis that the lender has recourse to the membership interests in head trust held by a non-Australian entity. In this regard, the exception for membership interests held by a non-Australian entity only applies to membership interests held **in the borrower**.

The ATO also maintains the view that credit support rights do not need to relate to the third party borrowing (e.g., examples 6, 19, and 21), rejecting submissions that credit support rights should properly be limited to those that are provided that induce the lender to make the loan.

PCG 2025/2: ATO compliance approach to restructures under the thin capitalisation rules

Schedule 3—third party debt test compliance approach

The compliance approaches aim to set out some safe harbours and allowable restructuring scenarios, for taxpayers to meet a relevant TPD condition. The ATO will not allocate compliance resources in respect of that condition, other than to confirm that the compliance approach is available.

Schedule 3 sets out the ATO's compliance approaches in the following circumstances:

Compliance approach	Examples	Compliance period
Restructuring to remove **recourse for payment** of a debt to assets that are not Australian assets	29 - 31	Between 22 June 2023 and 1 January 2027
Determining whether assets are **minor or insignificant**	32 and 33	Income years starting on or after 1 July 2023 and ending on or before 1 January 2027*
Determining whether entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its **commercial activities in connection with Australia** in the period prior to restructure and in the context of funding annual trust distributions	34	Income years starting on or after 1 July 2023 and ending on or before 1 January 2027*
Restructuring to comply with a **conduit financing condition**	35 - 37	Between 22 June 2023 and 1 January 2027

* The ATO will consider if the compliance approach needs to be extended at this time.

Reliance on the PCG is subject to the following caveats (noting one update to the draft PCG):

- Any restructure that occurs to ensure the debt arrangement can satisfy the TPD conditions is undertaken in a straightforward manner having regard to the circumstances, without any associated contrivance or artificiality and is on arm's-length terms;
- The restructure will not attract the application of part IVA of the Income Tax Assessment Act 1936;
- Prior to and following any restructure, the original arrangement satisfies the TPD conditions (other than the condition to which the compliance approach applies **or conditions where more than one compliance approach applies to a restructure);**
- The use of the financial arrangement does not change; and
- The quantum and rate of the financing arrangement do not materially change.

The update to the draft PCG clarifies that taxpayers can rely on more than one compliance approach.

Where a restructure is consistent with the specific requirements or examples in the PCG and the requirements listed above, the ATO will only allocate compliance resources to verify the compliance approach applies (i.e., the condition can be treated as being satisfied prior to the restructure). It is not clear how strictly the facts need to be aligned with a relevant PCG example to seek to rely on a compliance approach.

Restructuring to satisfy recourse conditions

The PCG provides the following examples:

- Amending the terms of an arrangement so that a third party lender does not have recourse to foreign assets of the tax obligor group (example 29);
- Removing recourse to foreign assets by transferring the assets to an associate entity that is not in the tax obligor group (example 30); and
- Amending the terms of a credit support agreement to satisfy s820-427A(5)(a)(iii)—a right that relates wholly to the creation or development of a capital gains tax (CGT) asset that is, or is reasonably expected to be, land situated in Australia (new example 31).

New example 31 involves amending the terms of a cost overrun support deed in relation to an Australian real property development so that it is limited to the development phase, with no such rights arising for the operational phase, to satisfy the requirement that the right relates wholly to the creation or development of a CGT asset.

Minor or insignificant asset exception safe harbour

Taxpayers must satisfy the following criteria prior to the restructure (unchanged from the draft PCG):

- The taxpayer makes reasonable efforts to identify minor or insignificant assets of the obligor group that are not Australian assets, and both of the following apply:
  - The market value of those assets identified is less than 1% of all of the assets to which the holder of the debt interest has recourse for the payment of the debt; and
  - The market value of each asset (or bundle of identical assets, such as a shareholding) does not exceed $1 million; and
- None of those assets are credit support rights.

Example 32 relates to a restructure to amend the terms of a loan so that the lender does not have recourse to the low value non-Australian assets. Presumably, a disposal of the non-Australian assets would also be a relevant restructure, although this is not explicitly stated.

Based on the final ruling, recourse to membership interests in the borrower are not permitted if the borrower holds, directly or indirectly, a non-Australian asset (even if the asset is minor or insignificant). This is relevant to a scenario where the owner of the membership interests in the borrower is not a member of the tax obligor group (e.g., on the basis that the lender does not have recourse to any assets of the entity other than the membership interests in the borrower) (refer to paragraph 820-427A(4)(b) and section 820-49).

New example 33 involves this type of situation and sets out a restructure to amend the terms of the loan so that the lender does not have recourse to any non-Australian assets (including those that are minor or insignificant), or to the membership interests in the borrower (which indirectly holds the minor or insignificant non-Australian asset). Alternatively, the group could dispose of the minor or insignificant non-Australian assets.

Commercial activities in connection with Australia

Under the final ruling, the ATO maintains the view that the payment or distribution of dividends or capital returns are not commercial activities in connection with Australia. The final PCG provides a new compliance approach in relation to this scenario, where taxpayers satisfy the following criteria:

- The taxpayer makes reasonable efforts to identify what the proceeds of issuing the debt interest are used for (including refinanced debt interests), and can demonstrate, with contemporaneous documentation, the extent to which the proceeds were used to fund commercial activities in connection with Australia consistent with TR 2025/2; and
- If proceeds of issuing the debt interest are used to fund annual trust distributions, the taxpayer can demonstrate that they are repaid in the manner described in example 34 of the PCG by the end of the compliance period.

Example 34 sets out the following limited scenario:

"Prior to and during the compliance period, Project Trust uses the debt facility for the payment of annual trust distributions to its investors. Those annual trust distributions do not exceed 10% of the available balance of the debt facility at the time they are made. …

Prior to and during the compliance period, Project Trust makes repayments towards its debt facility out of the revenues from its Australian business that equal or exceed the total of its annual trust distributions. …

Before the compliance period ends, Project Trust amends its governance documents and procedures and no longer pays distributions using the debt facility."

Example 34 only references debt funded distributions by **a trust**. It should be reasonable to expect that the same approach should be applied to debt funded distributions made by a company or partnership. However, it would be useful for the ATO to confirm this and whether any additional requirements would apply in those cases.

While the new compliance approach to address historical breaches is welcomed in the context of an issue that few, if any, outside the ATO would have foreseen, or even have considered as a correct interpretation of the law, prior to the release of the draft ruling, the terms of the compliance approach mean that it will have limited utility in many common circumstances—particularly in mitigating the impact of historical re-gearing arrangements that have been used to return significant profits or equity to investors (rather than to fund "annual trust distributions"). In that regard, it is unlikely that debt used to fund returns of capital upon a re-gearing of a business or project would satisfy the 10% threshold, nor be able to be repaid out of revenues of the Australian business before the end of the compliance period.

From a commercial perspective, the requirement to fund distributions from cash at bank, rather than drawing down on available facilities, perversely results in higher net debt deductions (i.e., interest costs on third party debt will exceed interest income on deposits).

Restructuring to satisfy conduit financing conditions

Broadly, to access the conduit financing modifications, the terms of the debt interest being on-lent, in respect of the costs incurred by the borrower, must be the same as the corresponding terms of the ultimate debt interest (with certain modifications).

The compliance approach applies to restructures consistent with the examples listed in the final PCG (largely unchanged from the draft PCG):

- Amending the terms of an intragroup loan to remove any mark up, so that the interest rates on the intercompany and external loan are the same (example 35);
- Amending the terms of an intragroup loan to delineate three separate intercompany loans, with no mark up or margin. Each intercompany loan has the same terms as a corresponding third party loan (example 36); and
- Amending the terms of an on-lent debt so that the interest expenditure is equal to the total payments under the on-lent debt (prior to the amendment) and under the back-to-back internal swap. At the same time, the back-to-back internal swap is closed out (example 37).

Example 37 has been updated in the final PCG to note that the ATO will seek to verify:

- The costs incurred in relation to the on-lent debt and the back-to-back internal swap are included in the third party earnings limit prior to the restructure;
- The gain or loss from closing out the back-to-back internal swap is not included as assessable income or deductible expenditure; and
- Following the restructure, the costs incurred under the amended on-lent debt are included in the third party earnings limit.

Generally, closing out a swap would give rise to a termination payment that would be assessable or deductible to each party, therefore verifying that the gain or loss from closing out the back-to-back internal swap is not included as assessable income or deductible expenditure seems to suggest that taxpayers should effectively ignore the operation of the law, which may not be consistent with tax governance policies, the obligations of the public officer and tax agent signing the return, and/or Foreign Investment Review Board tax conditions, noting that a PCG does not provide any legal protection from amendment, or interest and penalties.

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