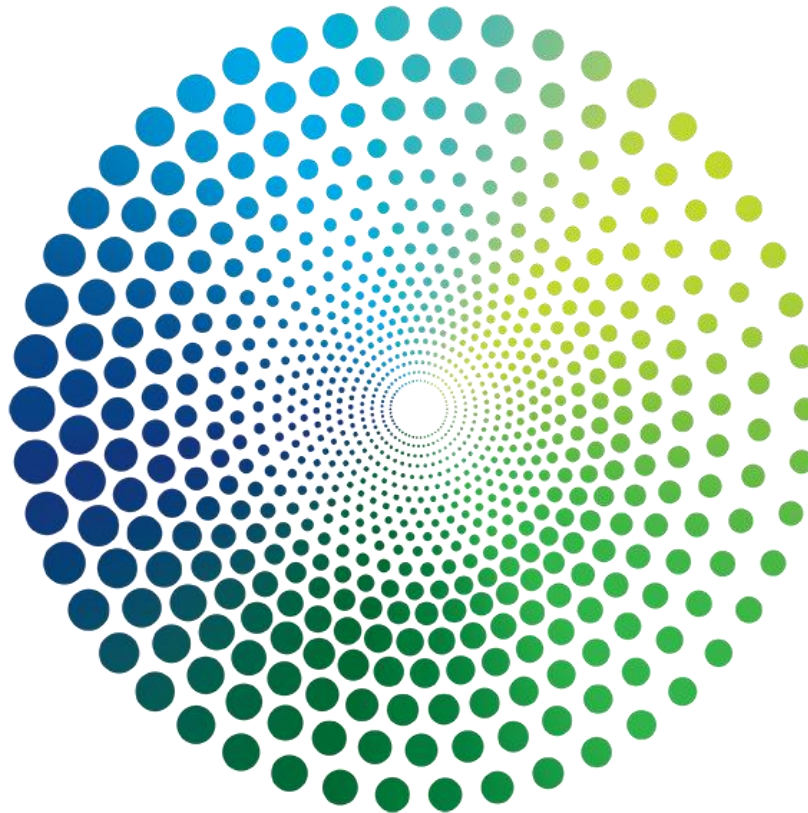




Tax Insights

ATO finalises PCG on new thin capitalisation and debt creation rules

On 20 August 2025, the Australian Taxation Office (ATO) released a final practical compliance guideline (PCG) PCG 2025/2 titled "Restructures and the thin capitalisation and debt deduction creation rules – ATO compliance approach." In October 2024, the ATO had previously issued a draft PCG, which it then updated in December 2024: PCG 2024/D3.

The ATO has also just released PCG 2025/2EC, which is a compendium of comments on submissions lodged on the draft PCG.

The final PCG is largely the same as the draft. A number of additional examples have been added to the final PCG, discussed below but, otherwise, there is no material shift on the stance of the ATO on these measures.

Background

The thin capitalisation (or interest limitation) 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. In very broad terms, the DDCR provisions can apply where:

- An entity (acquirer) acquires a capital gains tax (CGT) asset, or a legal or equitable obligation, from a related party (defined as an entity which is an “associate pair”) and the acquirer has related party debt deductions “wholly or partly in relation to” the acquisition or the holding of the CGT asset, or a legal or equitable obligation. Certain acquisitions are excluded: new membership interests, new depreciating assets, and certain debt interests; or
- An entity (payer) uses a related party financial arrangement to “fund or facilitate the funding of” a prescribed distribution to a related party recipient. In scope distributions include a dividend, return of capital, royalty, and other amounts.

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 of the Income Tax Assessment Act 1997 (ITAA 97) 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 positions schedule.

The term “restructure” is defined in the PCG to encompass any restructure or refinancing, including any change or reorganisation of group structures, 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.

The PCG applies to restructures entered into on or after 22 June 2023 (the date the relevant law was introduced into Parliament).

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 of PCG 2025/D3 currently remains in draft form and will be finalised at the same time as Taxation Ruling TR 2024/D3 Income tax: Aspects of the third-party debt test in Subdivision 820-EAB of the ITAA 97.
- Schedule 4: Restructures in response to the thin capitalisation changes.

Schedule 1

The majority of the examples in schedule 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 it should not be necessary to consider the DDCR and that the ATO is unlikely to apply its compliance resources 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). Since the draft PCG, the ATO has now expressly reserved its position to say that there may be a need to test at a later time if there is contrivance or artificiality. The point in time test also highlights that any transactions that could result in the parties becoming associate pairs leading up to the time of acquisition would need to be carefully considered.

Example 6 (previously 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 CGT assets from associate pairs and/or to fund dividends, royalties, or 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 where the cash pool entity is a related party.

Both examples 12 and 13 make it clear that it will be necessary to consider the application of the DDCR in cases involving complying division 7A loans, as highlighted by web guidance. Although expected, this may be a concerning 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, an offshore group company issues interest-bearing debt interests to foreign banks for the specific purpose of funding Mine 2's development. The borrowed funds are lent through Aus Co 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.

The final PCG now contains a new example 3, which assumes that, following completion of the development, Aus Sub Co 2 uses cash generated from operations to pay down its debt in accordance with the repayment schedule of the offshore third-party loan, and confirms that the ATO is unlikely to apply its compliance resources.

Given the facts in examples 2 and 3, the ATO conclusions are not surprising; however, the examples leave open whether regular repayments are seen to be required in other situations. In practice, a loan that is used to fund the acquisition of a substantial asset may remain in place until the asset is sold or the loan is refinanced.

New example 9 demonstrates the breadth of, and practical difficulties of dealing with, the DDCR. The example involves a \$100 million loan from a genuine third party, of which \$40 million is used to fund a related party acquisition, with the remaining loan funds presumably not being used for a disallowable DDCR transaction. The loan is paid down to \$35 million. At this stage, there is no role for the DDCR as the funds are not borrowed from a related party. The \$35 million loan is refinanced with a related party borrowing. The example concludes that the taxpayer would need to consider the application of the DDCR and the ATO is likely to consider applying its compliance resources.

While it is reasonably clear that the drawdown of \$100 million has been used to fund an "in-scope of DDCR" amount of \$40 million and an "out-of-scope of DDCR" amount of \$60 million, how is the repayment of \$70 million of the loan to be treated? A repayment of the "good loan," or the "bad loan," or both, or does it depend upon documentation which may or may not exist? The example also illustrates that an event many years prior (the \$40 million related party acquisition) may have no DDCR consequences at the time, but there may be a sting in the (long) tail many years later. From a policy perspective, the example also highlights how the DDCR can operate without any overall increase in debt (i.e., no overall new debt is "created" due to the refinancing).

Three new examples have been added (15, 16, and 17) to illustrate a "fair and reasonable" apportionment of interest expense where borrowed funds are used for "good DDCR" and "bad DDCR" purposes. The examples are simplistic in that they assume the use of funds can be clearly identified, and do not provide any meaningful insights in other cases.

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.

Schedule 2

Schedule 2 provides examples of restructures in response to the DDCR. It consists of eight low-risk restructures (including two new examples) and three high-risk restructures (including one new example).

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

The repayment of an associate pair (related party) loan funded by issuing new equity or from profits is generally seen as low risk (examples 23, 24, and 25); 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 19 and 27, which are at each end of the risk spectrum).

New example 20 sets out a low risk restructure involving the replacement of related party debt with a loan from an Australian bank, and sets out three relevant factors to consider. The restructure is low risk as it is not associated with:

- Any broader group reorganisation or refinancing;
- Any back-to-back or connected arrangements in connection with the loan from the Australian bank; or
- Any associated reduction in any third-party debt owing by an associate of the group parent.

Those same three criteria are applied in new example 21 to also conclude that the restructure is low risk. Another relevant factor in these examples seems to be that the refinancing with third party debt was necessary because the borrower does not have financial capacity to repay the loan.

Taxpayers intending to clean up offshore dormant structures can be comforted by example 22, 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 25 could be problematic from an (offshore) transfer pricing perspective, even if the restructure is seen as a low-risk restructure for Australian DDCR purposes.

New example 28 sets out a high risk restructure. AusCo has used a series of associate pair (related party) financing arrangements to fund ongoing “indirect” associate pair (related party) acquisitions. AusCo also has “an existing third-party debt facility from BankCo,” and the inference is that these funds have not been used for the relevant acquisitions.

The example proceeds on the basis that, contrary to the apparent facts, AusCo “contends” that the related party borrowings have been used to pay down existing bank debt owing to BankCo, followed by an immediate new drawdown from BankCo and it is these borrowed funds that are used to fund the “indirect” associate pair (related party) acquisitions. This is described as high risk as the “contended use of funds does not reflect the underlying arrangement.”

The risk issues in this example appear to arise from the mismatch between the apparent facts and the taxpayer’s contentions. On the other hand, if the funds from the existing third-party debt facility from BankCo had demonstrably been used to fund the related party acquisitions, the same conclusion would appear not to follow.

Yet again, these examples illustrate the need for careful and detailed fact-finding and documentation. The reality is that fact-finding will often be difficult in prior years, and “ideal” documentation will often not have been required in prior years and will often not exist.

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 states 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. In PCG 2025/2EC Item 14, the ATO seems to acknowledge the difficulties where tracing evidence is not available, and suggests that restructuring could be undertaken in such cases. Given that a refinancing of a loan is not seen to change the "use" of funds, this would require a full repayment of all relevant related party loans.

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

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.
- The ATO has conducted a review or audit of a restructure and reached a low risk rating, or a high assurance rating. This case was previously in the green zone.

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, or the circumstances that informed the ATO rating.

A restructure will also be in the white zone if the thin capitalisation rules do not apply on the basis that total relevant debt deductions are \$2 million or less.

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 202 of the PCG (set out below).

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 202 states that restructures are only low risk where the arrangements are otherwise commercial, and 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.

Deloitte Australia comments

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.

In the future, taxpayers will seek to comply with these rules with contemporaneous documentation and careful management of cash flows. Even in that case, the DDCR rules are so broad (does a borrowing of \$X "facilitate the funding" of \$Y) and contain a specific avoidance rule (which has no purpose test) that DDCR risks remain.

The DDCR risks are particularly pronounced where, at the commencement of these rules, taxpayers have related party borrowings that have their origins many years ago. Being able to fully and demonstrably trace the history of the borrowing of funds, the use of the funds and related repayment of funds will be extremely challenging. And in these cases, the ATO makes it clear that the onus is on the taxpayer to show that the DDCR does not apply.

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