APPENDIX D – AMBIGUITY IN PCG 2025/2, SCHEDULE 3 COMPLIANCE APPROACHES

1. The purpose of this document is to seek clarification of the compliance approaches adopted by the ATO in Schedule 3 in PCG 2025/2 regarding the third party debt test (**TPDT**).

2. We believe it is critical that these ambiguities be addressed so that taxpayers can apply the PCG to their circumstances with a high degree of certainty.

3. It is noted that paragraph 274 states that the Commissioner will review the compliance approaches and we are hopeful that the Commissioner is therefore open to adopting recommendations to assist taxpayers in complying with the PCG.

Compliance approach for small asset holding – example 32

4. Paragraphs 295 to 298 make references to a restructure. Paragraph 302 in example 32 states that the loan is amended in order to comply with the TPDT after the compliance period ends. Presumably the making of those amendments is the relevant restructure.

5. It is not clear however if a restructure is in fact required in order to be able to apply the compliance approach. The criteria in paragraph 298 does not expressly require that recourse to minor or insignificant assets needs to be removed in order to satisfy the TPDT during the compliance period.

6. For example, a taxpayer may simply stop applying the TPDT in the income years following the compliance period, or may not even be subject to Division 820 in subsequent years.

Recommendation 1 – Clarify whether a taxpayer can simply rely on the $1m / 1% compliance approach for income years ending on or before 1 January 2027 without needing to undertake a restructure of any kind.

7. The example involves a loan of $1 billion and also states that the value of CFC is approximately 1% of all of the assets to which the lender has recourse. In order to meet the criteria under paragraph 298, the market value of the shares in CFC would need to be less than $1 million. If so, this suggests that the value of total assets to which the lender has recourse is $100 million or less. This would appear to be inconsistent with the statement that the lender has recourse to all assets of the group which has just borrowed $1 billion.

Recommendation 2 – Clarify the values of assets in example 32 and explain how this meets the condition that no single asset or bundle of identical assets be worth more than $1 million.

Compliance approach for small asset holding and subsection 820-427A(4) – example 33

8. Similar to the comments above, it is not clear whether a restructure is in fact required to be able to rely on the compliance approach where the lender has recourse to membership interests in the borrower that has a direct or indirect interest in a non-Australian asset.

Recommendation 3 – Clarify whether a taxpayer can simply rely on the $1m / 1% compliance approach for income years ending on or before 1 January 2027 without needing to undertake a restructure of any kind in respect of the interaction with subsection 820-427A(4).

9. The example involves amending the terms of the loan to remove recourse to non-Australian assets <u>OR</u> to the membership interests in the borrower. It is unclear whether this requires that recourse needs to be removed to both of these things. It may be that the ‘or’ should be interpreted to mean ‘and’.

10. If the loan agreement is merely amended to remove recourse to the non-Australian assets themselves, this would not appear to comply with the ATO’s interpretation of s 820-427A(4)(b)

as contained in example 13 in TR 2025/2 as there would still remain recourse to membership interests in an entity which holds an indirect interest in a non-Australian asset.

11. Further, if the non-Australian assets of Asset Trust are truly minor or insignificant, then it should not be necessary to remove recourse to those assets as such recourse is permissible under the law.

12. Overall, if the example is focused on the interaction with s 820-427A(4)(b), then it should focus on the recourse to the membership interests only.

13. For completeness, the alternative approach of disposing of the non-Australian asset should also result in satisfaction with the TPDT going forward.

Recommendation 4 – Clarify example 33 by removing the reference to the removal of recourse to the non-Australian asset.

14. Paragraph 306 states that the terms of the loan are amended to remove recourse to al non-Australian assets, whether minor or not.

15. If Asset Trust held non-Australian assets that were not minor, it is not clear whether this compliance approach can apply. It is contained in a section about 'minor or insignificant assets' and the title of example 33 is 'compliance approach for <u>small asset holding</u> and subsection 820-427A(4)'.

16. Examples 29 and 30 contain a compliance approach that allows the removal or recourse to non-Australian assets of any size. A similar compliance approach should apply for compliance with the interaction with s 820-427A(4)(b).

17. The example also states that the minor or insignificant asset is less than 1% of all of the assets to which the holder of the debt interest has recourse to. The relevance of the 1% is not clear as example states that the asset is minor or insignificant as a fact. The reference to the 1% is part of a compliance approach to treat assets as minor or insignificant in a transitional period. If the asset is presumed to be minor or insignificant then presumably the 1% test is irrelevant. If the focus of the example is the interaction between s 820-427A(4)(b) and assets that are small (i.e. valued at less than $1m and represent less than 1% of all recourse) but not <u>actually</u> minor or insignificant under the Commissioner's view, then the foreign asset should not be described as minor or insignificant.

Recommendation 5 – Clarify whether the interaction with subsection 820-427A(4) is limited only to (1) minor or insignificant assets (2) assets that meet the 1% & $1m rule but are not actually minor or insignificant or (3) any non-Australian assets.

It would be preferable if the approach applies to non-Australian assets of any size. The compliance approach in example 30 and 31 that allows removal of direct recourse to non-Australian assets of any size should extend to removal or recourse to membership interests in the borrower than holds an interest in any non-Australian asset. Example 33 could be retained for small asset holdings and modified to state that the ATO will not apply compliance resources to the compliance period where the lender has recourse to membership interests in the borrower where the borrower has holds an interest in a non-Australian asset that meets the 1% / $1m de minimis but that this doesn't require a restructure of any kind.

Compliance approach for commercial activities in connection with Australia – example 34

18. The second of the criteria in paragraph 311 for this compliance approach merely requires that the taxpayer demonstrates that they repaid borrowings in the manner described in example 34.

19. Example 34 includes as one of the relevant facts that the annual trust distributions of Project Trust were (1) funded by a debt facility and (2) those trust distributions do not exceed 10% of the available balance of the debt facility at the time they were made.

20. It is not clear whether these are merely background facts in the example or whether they introduce conditions in order to access the compliance approach. The conditions in the compliance approach asks one to consider the manner in which the debt is repaid, rather than how it was obtained.

21. Many readers may conclude that this is a condition of the compliance approach given how specific it is. However, a compliance approach should focus on the use of the borrowed funds and repayment of those funds, rather than the particulars of the borrowing. For example, the compliance approach should be available if a standalone debt interest such as a loan (i.e. 100% of that debt) was issued to fund some annual trust distributions during the compliance period rather than requiring a small part of a debt facility being the source of the funding.

Recommendation 6 – Clarify whether the compliance approach for the use funds to repay trust distributions is only limited to situations where the funds were obtained under a debt facility where the borrowing represented a drawdown of less than 10% of the available balance. If this is a requirement, include these in paragraph 311. Otherwise clarify that the 10% of the debt facility is merely facts in an example and not a condition that must be satisfied.

Compliance approach for conduit financing same terms requirement – example 35

22. Example 35 states that the entire mark-up on the intercompany loan is removed so that the interest rates are on the intercompany and external loans are the same.

23. Subsection 820-427C(2) allows for a mark-up to recover reasonable administrative costs such that removal of the mark-up entirely could result in the conduit making a loss. This could raise questions about the deductibility of its own costs under section 8-1 if they cannot be passed on to the ultimate borrower.

Recommendation 7 – Clarify that the mark-up need only be removed to the extent it goes beyond recovering reasonable administrative costs in order for the compliance approach to apply.

Compliance approach for conduit financing and internal swaps – example 37

24. Example 37 states that the ATO will verify that the gain or loss from closing out the back-to-back internal swap is not includes as assessable or deductible to either party to the swap.

25. On one reading this suggests that the actual tax effect of closing out the swap results in a no assessable income or deductions to arise from the transaction and if not, the compliance approach is not available.

26. An alternative reading is that regardless of the outcome under the tax law, that neither party includes income or deductions in respect of this transaction.

Recommendation 8 – Clarify whether closing out the internal swap (1) requires a tax-neutral outcome for each party to the transaction or (2) whether the Commissioner will simply disregard what would be the correct tax treatment for each party and requires the parties not to include any assessable gain or deductible loss that actually arises.