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26 June 2026

**Board of Taxation Secretariat**

C/O - The Treasury  
Langton Crescent  
PARKES ACT 2600

**By Email:** [taxboard@taxboard.gov.au](mailto:taxboard@taxboard.gov.au)

Dear Secretariat

**STATUTORY REVIEW OF AUSTRALIA'S THIN CAPITALISATION REFORMS**

1. Thank you for the opportunity to provide comments on the Board of Taxation's ("**Board**") review of the reforms made to Australia's thin capitalisation rules ("**Review**") in Schedule 2 to the *Treasury Laws Amendment (Making Multinationals Pay their Fair Share—Integrity and Transparency Act) 2024* ("**Amending Act**").
2. Pitcher Partners specialises in advising taxpayers in what is commonly referred to as the middle market. Accordingly, we service many taxpayers that are impacted by the thin capitalisation rules.
3. We highlight that for the purposes of Division 30 of the *Tax Agent Services Act 2009* and, in particular, the amendments to the Code of Conduct by the *Tax Agent Services (Code of Professional Conduct) Determination 2024* ("**Determination**"), all of the comments made in this submission are directly relevant to us as a firm and our clients. While this may result in a conflict of interest for the purposes of section 20 of the Determination, we highlight that we have tried to ensure that our comments and suggestions in this submission are balanced and consistent with the policy, principles and intention of the rules as we understand them.

**KEY MESSAGES**

4. We have responded to each of the Board's questions in Appendix A below. However, we would like to clearly state our three biggest concerns with the current thin capitalisation provisions.

### **Tax neutral outcomes**

5. First, the reforms are not operating in a commercially neutral way. They favour tax consolidated corporate groups and disadvantage non-consolidated groups, particularly trust-based middle-market structures.
6. The new rules allow tax consolidated groups to effectively pool capacity across the group, including aggregating tax EBITDA and interest income and ignoring intra-group transactions. This means capacity is preserved and fully utilised at the group level. Further, they ignore intra-group transactions for the purposes of the DDCR provisions where debt is wholly between group entities.
7. By contrast, non-consolidated groups cannot efficiently share excess capacity. This is particularly acute for trust structures and groups with less than 50% ownership links, where excess tax EBITDA can be stranded and unused. Further, the DDCR provisions recognise Australian intra-group debt arrangements in cases where there is no risk to the revenue.
8. The result is that economically similar groups can have materially different outcomes purely due to legal structure, with the rules applying more harshly to the middle market.

### **Debt deduction creation rules (DDCR)**

9. Secondly, the DDCR is not operating as a targeted integrity rule. It is too broad and uncertain in its operation.
10. The rule applies well beyond artificial or tax-driven “debt creation” arrangements. It can extend to ordinary domestic transactions, refinancing, and long-standing group structures, even where there is no base erosion or manipulation of thin capitalisation outcomes.
11. At the same time, the rules can be circumvented in cases that appear to fall within their intended scope, particularly due to timing and associate-pair requirements. Combined with unclear concepts such as indirect funding and tracing, the DDCR creates significant uncertainty and compliance difficulty, without being tightly aligned to any mischief it is supposed to address.

### **Compliance burden**

12. Thirdly, the compliance burden imposed by the regime is disproportionate to the revenue risk, particularly for middle-market taxpayers.
13. The clearest example is the \$2 million *de minimis* threshold, which continues to operate on a gross basis despite the FRT now focusing on net debt deductions. This can bring taxpayers fully within the regime, including the DDCR, even where only a very small quantum of net deductions are actually at risk.
14. This issue is exacerbated in non-consolidated groups, where intra-group lending can inflate gross deductions and trigger the rules unnecessarily. More broadly, the complexity of the provisions, including associate entity rules, tax EBITDA calculations and tracing requirements, can result in significant compliance costs that are not commensurate with the underlying integrity risk.

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15. We If you would welcome the opportunity to meet with you to discuss our submission. If you would like to discuss any aspect with us, please contact either Leo Gouzenfiter on (03) 8612 9674 or me on (03) 8610 5170.

Yours sincerely



A M KOKKINOS  
Executive Director

## APPENDIX A – DETAILED COMMENTS

16. Our submissions address the terms of reference contained in the Review. All legislative references in our submission are to the *Income Tax Assessment Act 1997* (“**ITAA 1997**”) unless otherwise indicated.

### **Item 1: The overall performance of the amendments in strengthening Australia’s thin capitalisation regime to address risks arising from the use of excessive debt deductions**

#### ***General observations***

17. We do not have empirical evidence to address this topic in detail. As a general observation however, we highlight that the amendments favour certain industries (those that are less capital intensive) and is less favourable for other industries (those that are more capital-intensive).
18. In particular, those in the property sector are generally worse off as the nature of their assets require significant borrowings without creating excessive financial risk. Such entities could more easily obtain certainty under the former thin capitalisation rules by setting their capital structure consistent with the 60% asset-based safe harbour. Under the new rules, that same amount of debt is generally less likely to result in full deductibility under the fixed ratio test (“**FRT**”) and also produces less certain outcomes due to potential fluctuations in earnings.
19. By contrast, entities such as money lenders, that are not classified as financial entities, may have more favourable outcomes given that the FRT can only deny deductions to the extent the entity has net debt deductions for the year. Entities that borrow and on-lend may far more easily determine their thin capitalisation outcomes where their interest income exceeds their debt deductions for an income year, resulting in full deductibility under the FRT regardless of how thinly capitalised the entity is.

#### ***Consolidated group vs non-consolidated groups***

20. The new thin capitalisation rules also clearly favour consolidated corporate groups over non-consolidated groups, particularly those that operate through trusts, mainly due to the limited ability to share excess tax EBITDA between group entities.
21. Tax consolidated groups are able to achieve the most optimal outcomes due to the aggregation of all tax EBITDA and interest income at the level of the head entity under the single entity rule such that not a single dollar of group capacity is wasted. By contrast, non-consolidated groups may have an outcome where one entity has excess capacity and another entity may have deductions denied under the FRT for the following reasons:
- 21.1. sharing of excess tax EBITDA is only available from subsidiaries to parents<sup>1</sup> whereas consolidated groups allow sharing between ‘sister entities’ as well as from parent to subsidiary;
- 21.2. tax EBITDA amounts can only be attributed to entities with a 50% or greater direct control interest meaning that a wholly-owned subsidiary with a 51%/49%

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<sup>1</sup> Section 820-60 only applies where an entity has a TC direct control interest in another entity.

ownership by two other group members in a non-consolidated group would result in a wastage of 49% of the excess as compared to a tax consolidated group.;

- 21.3. Discretionary trusts are not able to be ‘controlling entities’<sup>2</sup> or ‘controlled entities’ in a non-consolidated group, as compared to discretionary trusts that are subsidiary members of a tax consolidated group.
- 21.4. Excess amounts cannot be attributed to a controlled entity where it excess is due to an entity’s interest income exceeding its debt deductions for the year resulting in negative debt deductions,<sup>3</sup> Such excess is permanently wasted. By contrast, a tax consolidated group would simply be able to take this excess interest income into account at the head company level allowing for greater FRT capacity for the group.
22. More equitable treatment between tax consolidated group and non-consolidated groups, being those more prevalent in the middle market, would result in less arbitrary outcomes. While the sharing of excess amounts horizontally may not be feasible, fairer outcomes could be achieved with changes such as permitting a discretionary trust to be a controlling entity,<sup>4</sup> removing the modified treatment of negative net debt deductions from the method statement and allowing attribution where controlling interest is between 10% and 50%. Absent such changes, the thin capitalisation provisions apply more harshly to middle-market groups that are unable to consolidate for income tax purposes.
23. We highlight that the first reading of the Amending Act did not contain any excess interest capacity rules. On page 93 of the EM it was stated:
- Feedback was considered on the inclusion of an ability to share excess interest capacity within trust groups, but ultimately decided against including this for simplicity and integrity reasons.*
24. While it is welcome that some form of excess capacity rule was introduced, we believe that our recommendations above achieve fair outcomes for all taxpayers and would not add undue complexity or integrity concerns. We believe that having a broader excess tax EBITDA rule could reduce the complexity of the provisions.
25. Additionally, tax consolidated groups obtain other forms of favourable treatment under the new rules such as:
- 25.1. The SER ignores intra-group transactions and accordingly does not give rise to the potential application of the debt deduction creation rules (“DDCR”) where there are intragroup asset transfers or distributions. This can be compared to non-consolidated groups where such transactions are recognised (e.g. sale of trading stock or a capital asset between related parties on interest-bearing vendor-finance terms).
- 25.2. Intra-group interest is not recognised (nor subject to denial) when considering whether the tax consolidated group satisfies the \$2 million *de minimis*<sup>5</sup> (based

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<sup>2</sup> Subsection 820-60(1). By way of contrast, any kind of entity could (including individuals) can benefit from an associate entity excess amount under section 820-920 under the safe harbour debt method.

<sup>3</sup> Step 1(a) of the method statement in subsection 820-60(3).

<sup>4</sup> That is, allowing excess amount to be attributed up to a discretionary trust, but not to flow through any further beyond a discretionary trust.

<sup>5</sup> Section 820-35.

on gross debt deductions on an associate entity-inclusive basis). This can be compared to a non-tax consolidated group which can duplicate the counting of gross debt deductions when there are back-to-back loans. We highlight that such an issue is highly prevalent in the middle market, as most groups would have a single 'financing entity' within the group that on lends bank debt to other group entities. Such arrangements result in a duplication of the debt deductions counted for the \$2 million *de minimis* exclusion.

- 25.3. Tax consolidation offers a simpler ability to satisfy the third party debt test where amounts are on-lent within the group without the need to satisfy conduit financing rules such as the 'same terms' requirement.<sup>6</sup>
- 25.4. There are specific part-year rules that appear to apply to tax consolidated groups, whereas such rules do not apply to standalone entities.<sup>7</sup>

### ***Do the new rules prevent excessive debt deductions?***

26. In our view, each method (i.e. safe harbour balance sheet or earnings method) is effectively an arbitrary method of controlling the level of debt used to finance an entity. In certain circumstances each method may produce a different result, which may or may not be appropriate in the circumstances.
27. For example, the former safe harbour balance sheet approach allowed more direct limits to be placed on excess gearing by a particular entity. To the extent that an entity artificially loads itself with debt to take advantage of additional capacity under the safe harbour, Part IVA or a separate integrity rule in the nature of the DDCR could be adopted or applied in respect of such arrangements.
28. Paragraph 2.145 of the Explanatory Memorandum ("**EM**") to the Amending Act states that the risk of excessive debt deductions created in particular circumstances  
  
*"...may only ever indirectly, and at most, be partially limited by the thin capitalisation rules."*
29. We highlight that this comment seems to contract the statement in paragraph 2.9 of the EM which comments on the difference between the old and new rules:  
  
*This approach indirectly limits the amount of debt an entity can use to generate allowable interest deductions. The OECD best practice sets out a direct approach to limit the interest expenses an entity can claim.*
30. While it is true the balance sheet method is an indirect way of limiting the deductibility of interest expenses, it is somewhat misleading to characterise the FRT as being a direct approach just because the FRT limit is directly compared to debt deductions (or more accurately, net debt deductions).
31. Both the balance sheet method and the FRT adopt arbitrary formulas that may result in a denial of debt deductions. Both are an indirect way to deal with the risk of excessive debt deductions by Australian entities that are members of multinational groups. Whether the mechanics in the rules consider the amount of (net) debt deductions, or

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<sup>6</sup> Paragraph 820-427C(1)(d).

<sup>7</sup> Subsection 820-853(1) allows a head company of a consolidated group to be a general class investor for part of an income year while subsection 820-46(2) treats a standalone entity as being a general class investor for an entire income year if they met the requirements for all or part of the income year.

instead consider the level of gearing, both methods ultimately adopt a proxy of what is seen to be an acceptable level of debt deductions.

32. Either method would not directly address the risk of 'debt dumping' into Australia to take advantage of having excess capacity under the either the old or the new rules.
33. This is highlighted in the decision of the Federal Court in *Mylan Australia Holding Pty Ltd v FCT (No 2)*<sup>8</sup> which involved the establishment of local subsidiary by the Mylan Group to acquire the Australian subsidiary of the Merck Group as part of a larger acquisition of Merck's global generics pharmaceutical business. The case is useful as neither the current nor former rules would appear to counteract the arrangement.
34. The establishment of the local subsidiary allowed debt deductions to arise in Australia as it funded by a mix of 25% equity and 75% debt, such mixture specifically chosen to align with the safe harbour debt limits at the time. When considering the plausibility of the Commissioner's alternative postulate under Part IVA, Button J stated:

*305. First, no acquisition structure would have been adopted that would have seen greater debt assumed in Australia than the then-applicable thin capitalisation rules would have allowed. It should be noted that none of the four remaining counterfactuals posited debt in excess of those thin capitalisation limits. In 2007, Australia's thin capitalisation rules operated to limit the deductibility of interest where, broadly speaking, the taxpayer had a debt to equity ratio of more than 3:1.*

35. The Court found that setting the funding structure for a company to ensure that thin capitalisation limits would not be breached was entirely uncontroversial. Critically, however, this was only justifiable where the quantum of debt could be commercially justified, which was found to be the case in these particular circumstances:

*312. In my view, if the schemes had not been entered into, MAPL would still have been capitalised with 75% debt. It is clear from the evidence that, when Mylan considered having local acquisition entities take on debt to acquire relevant Merck subsidiaries, the debt levels it projected tracked the applicable thin capitalisation limits in the various jurisdictions. As noted above, at the relevant time, the applicable debt to equity ratio to stay within the thin capitalisation safe harbour in Australia was 3:1 (with no difference depending on whether the lender was an external lender or a group company). According to a memorandum by Deloitte dated 20 July 2007, there was no thin capitalisation limit on third party debt in Canada or Japan, but a limit of 2:1 and 3:1 for internal debt in Canada and Japan respectively. Although the Commissioner said that there was a thin capitalisation limit of 7:1 applicable to external debt in those countries, nothing turns on the difference between the parties' positions on whether there was a thin capitalisation limit on external debt in Canada and Japan. The relevant point is that, when Mylan ultimately proceeded with Canada taking on intercompany (not external) debt, the amount borrowed dropped to correspond with the safe harbour limit in Canada that applied to internal debt.*

*313. Although the Commissioner made much of Mylan tracking the safe harbour limits in relation to the dominant purpose enquiry, the relevant point for present purposes is that, where it decided to capitalise a local*

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<sup>8</sup> [2024] FCA 253.

*acquisition vehicle with a mix of debt and equity, Mylan was careful not to exceed the safe harbour; that much is to be expected...*

36. Button J further went on to comment that the local subsidiary would reasonably be expected to reduce the level of debt to stay within the thin capitalisation safe harbour when it was reduced from 75% to 60%:

*385. In my view, and as the Commissioner submitted, MAPL would also have made such additional payments as were necessary to ensure it remained within the thin capitalisation safe harbour limit (including as it was varied — to 1.5:1 (for non-ADI entities) — by Pt 1, Sch 1 to the Tax and Superannuation Laws Amendment (2014 Measures No. 4) Act 2014 (Cth)), which would have been funded (as they were on the facts as they occurred) by additional equity.*

37. In summary, the taxpayer was found to not have taken on excessive debt. Arguably, an even greater amount of debt could have been justified using the arm's length debt amount. However, the safe harbour debt method provided an easy and predictable outcome under the thin capitalisation rules.
38. If the reduction of the thin capitalisation limit from 75% to 60% and then the subsequent change to the earnings-based FRT resulted in less debt deductions<sup>9</sup> being allowed in Australia, this would merely act as an arbitrary limit that gave rise to a higher tax burden rather than preventing the use of excessive debt in any way, as the quantum of debt was justifiable and found not to be excessive.
39. This case highlights that the only way to directly address the risk of the use of *excessive debt* in Australia (rather than merely arbitrarily limiting it) is to only allow for an arm's length debt amount to be used. Where in the interests of certainty and reduced compliance costs an arbitrary limit is set, whether a balance sheet method or earnings-based method, an integrity rule such a DDCR-type rule (or Part IVA) would may be necessary to address the risk of excessive debt on a case-by-case basis.
40. This is the current status of the law as the DDCR is applicable both to general class investors using the FRT or group ratio test and financial entities (non-ADIs) using the balance sheet safe harbour or worldwide gearing debt methods.
41. Finally, we note that the arrangement in *Mylan* was implemented in a commercial way. We further note that even if this case were to be considered a 'debt dumping' case, the DDCR in its current form would unlikely apply to the arrangement. This point is explained in detail in the next section. However, we note this here as it demonstrates how the results under either method can be somewhat arbitrary depending on the facts.

#### **Debt deduction creation rules**

42. Our view is that the DDCR in its current form is not currently fit for purpose to address the particular risk of using excessive debt in Australia by taking advantage of the statutory limits in an appropriate way. We provide more detailed comments in relation to the DDCR in our submission below.
43. At a high level, the ostensible goal of the DDCR, as articulated in the following EM passages, is to support the new thin capitalisation rules by targeting schemes that seek

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<sup>9</sup> Depending on the level of earnings, the change to the FRT could allow a greater amount of debt deductions.

to artificially introduce excessive debt into Australia that may take advantage of the arbitrary limits under the relevant default tests.

*2.146 New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification.*

*2.147 Subdivision 820-EAA represents a modernised version of the debt creation rules in former Division 16G of the ITAA 1936. Subdivision 820-EAA is consistent with Chapter 9 of the OECD's BEPS Action 4 Report (specifically paragraphs 173 and 174 of that report) which recognises the need for supplementary rules to prevent debt deduction creation.*

44. Those paragraphs of the OECD Report highlight the need for targeted rules “where base erosion or profit shifting” remain despite the adoption of interest limitation rules.
45. One aspect of the rules which fail the stated objectives of the DDCR is that the kinds of transactions chosen are not necessarily indicators of “schemes that lack genuine commercial justification”. The rules simply have no regard to whether the transactions occur under a scheme of any kind and whether such a scheme was one that lacked commercial justification. Some of the indirect rules in particular are stated to apply regardless of any coherent scheme or plan and can result in a denial of deduction merely because two or more otherwise unconnected transactions occur coincidentally.
46. Another aspect of the DDCR which clearly fails these objectives is that it applies to wholly-domestic transactions which may have the effect of shifting income from one Australian entity to another Australian entity that pays the same or even high rates of tax on the ‘shifted profits’. Accordingly, in such cases, there is no base erosion to justify the application of the DDCR to such arrangements.
47. The application to domestic transactions should only apply in limited circumstances where there is a need to protect the integrity of the thin capitalisation rules. For example, A Co 1’s FRT limit for the year is \$100 greater than its net debt deductions and A Co 2 (a related party) has net debt deductions that exceed its FRT limit for the year by \$100. In order to prevent A Co 2 from being disallowed \$100 of debt deductions under the fixed ratio test, a DDCR-type transaction is entered into. For example, A Co 2 disposes of an asset to A Co 1 for \$1,000, which is financed by way of a loan from A Co 2 for \$1,000 at a 10% interest rate. This results in the creation of artificial or contrived debt owed by A Co 1 to A Co 2 under which \$100 of debt deductions are paid that year. This results in both entities obtaining full deductibility under the FRT.
48. The DDCR may be necessary in such a case to prevent manipulation of outcomes under the FRT. However, if A Co 1 and A Co 2 both have excess capacity under the FRT, before considering the impact of any borrowing between them, applying the DDCR to a related-party transaction between them would simply result in arbitrary denials of deductions rather than the targeting of any mischief.
49. Additionally, where entities are not even subject to the thin capitalisation rules, for example, outbound groups excluded under the 90% Australian asset test contained in section 820-37, the DDCR should have no role to play. If the DDCR is intended to prevent excessive debt deductions arising from artificial arrangements, it is unclear why it should apply in circumstances where thin capitalisation regime does not otherwise operate.

50. Put another way, the risk of excessive debt being allocated to Australia, which is the underlying concern addressed by the thin capitalisation rules, is regarded as minimal for multinational groups which have at least 90% of their assets located in Australia.
51. It may be argued that such groups may be large in size, such that the quantum of debt deductions at risk may be large in an absolute sense, despite being small in a relative sense to the size of the group. However, that is an argument for the appropriateness of the exclusion contained in section 820-37 in general, rather than whether entities that can apply that exception from Division 820 in general should still nevertheless have to apply the DDCR.
52. Example 22 in PCG 2025/2 highlights this absurdity by illustrating the potential application of the DDCR merely because an Australian entity owns a dormant foreign subsidiary of no value. Simply cancelling or selling the shares in that subsidiary would take the Australian entity out of the rules.
53. There is no coherent reason why the mere existence of such a subsidiary should be the difference between potentially significant denials of debt deduction under the DDCR (and all the associated compliance costs) and the non-application of DDCR in its entirety.
54. Further, the non-application of the DDCR from the mere absence a foreign subsidiary from the group is a tacit acceptance that wholly domestic arrangements do not need to be subject to a specific integrity rule preventing the creation of artificial debt between related Australian parties. This provides further support for our contention that domestic arrangements should only be subject to the DDCR in limited circumstances, being those where the default rules may be manipulated. Where all domestic entities are subject to the exception in section 820-37, there are no outcomes to manipulate under the default rules which are simply not applicable.
55. If it is nevertheless considered appropriate to apply the DDCR to groups that would otherwise satisfy the exception in section 820-37 on the basis that they may be large in size, a targeted *de minimis* should be available to prevent absurd outcomes where the foreign presence is immaterial. For example, where the total assets of the group are less than \$100 million, section 820-37 would apply if the Australian assets represent \$90 million or more of those assets. In those circumstances, where the foreign investment does not exceed \$10 million, there would generally be limited scope in an absolute sense for the shifting of debt deductions into Australia.<sup>10</sup>
56. We further highlight that, in addition to its somewhat arbitrary and poorly targeted application, the DDCR does not appear to effectively address certain cases which appear to be within its policy scope.
57. For example, we again highlight the case of *Mylan*. The target company Alphapharm Pty Ltd was a subsidiary of a Netherlands holding company MGGBV. The broader Mylan group acquired both Alphapharm as well as its holding company, with the acquisition of Alphapharm occurring just before the acquisition of MGGBV by US resident Mylan Inc. Had Mylan Inc simply acquired all its targets via the acquisition of MGGBV, it could have acquired Alphapharm without establishing an Australian holding

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<sup>10</sup> By way of comparison, we note that in PCG 2017/2, the Commissioner considers \$50 million or less of cross-border loans as representing "low level inbound loans".

structure into which debt could be introduced giving rise Australian debt deductions.<sup>11</sup> This was the Commissioner's primary counterfactual:

*6. The Commissioner considered that the entry into the wider scheme (which included the incorporation of the local Australian holding company structure (MAPL and MAHPL)) generated a tax benefit, being all the interest deductions on PN A2 (and a subsequent note, entered into in 2014, referred to as **PN A4**). This was on the basis of the Commissioner's view that, had the wider scheme not been pursued, the shares in Alphapharm would not have been separately acquired through a local Australian holding company structure. Rather, Alphapharm would have remained a subsidiary of the Netherlands company, Merck Generics Group B.V. (**MGGBV**) and would have become part of the Mylan group with the acquisition of MGGBV. In this scenario (described as the **primary counterfactual**), MAPL would not have acquired the shares in Alphapharm and would not have incurred interest expenses under PN A2.*

58. The DDCR would seemingly fail to apply to the debt deductions that arise from this transaction due to a mere timing issue.
59. Example 1 in PCG 2025/2, particularly paragraph 77, outlines the Commissioner's view that testing the associate pair requirement only needs to be done at the time of the relevant acquisition and not tested at any later point in time.
60. Purchasing the Australian subsidiary out from underneath its holding company, immediately before acquiring that holding company (once it no longer holds that subsidiary), would seemingly be the kind of transaction that should be the target of the DDCR where it facilitates the introduction of debt in Australia.
61. However, the DDCR would seemingly not apply in these circumstances. At the time of acquiring Alphapharm on 2 October 2007,<sup>12</sup> the local Mylan subsidiary was not an associate pair of MGGBV, being entity from which it acquired those shares. It only became an associate pair at a later time (i.e. later that same day) when another member of the Mylan corporate group acquired the shares in MGGBV.
62. If the ordering of the transaction steps were reversed, that is, the Mylan corporate group first acquiring MGGBV and then had its local subsidiary acquire Alphapharm from MGGBV, this would seemingly satisfy the requirement that the acquisition of the shares (funded by related cross-border debt) was an acquisition from an associate pair that satisfied the requirements of the DDCR.
63. The DDCR is in urgent need of reform. It should be redesigned in a way so that its objective is clear, appropriately targets arrangements of concern (being those with a purpose of manipulating the thin capitalisation rules) and has appropriate exclusions for entities and transaction that are of low or no risk of resulting in the mischief that the rules seek to prevented.

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<sup>11</sup> Any interest expenses incurred by a foreign holding company to fund the acquisition would not be deductible in Australia as it may only have a nexus to dividends that are NANE in the hands of the foreign company.

<sup>12</sup> Which may be earlier for CGT and DDCR purposes which relies on the definition of "acquire" in Division 109 which considers contract date.

**Item 2: Any minor and technical drafting changes which are necessary for the practical administration of the laws, with a particular focus on the third-party debt test provisions and related undefined legislative terms.**

64. The Review presents a great opportunity to clean up various drafting issues contained in the amendments to the thin capitalisation rules.
65. We include in Appendix B a register of such drafting errors and issues that should be clarified through legislative amendment. In addition to our issues register, we make additional comments about particular issues. Some of these issues representing what we believe to be drafting defects while others represent areas which require further clarification, whether through further legislation or ATO guidance.
66. As an additional general observation, we note that the associate entity rules have become far too complex and uncertain in their application. While we have provided specific examples below, we make the following general comments on this issue.
67. Section 820-905 was always a complex provision to apply with further complexity added following amendments made in 2014. The Amending Act added an extraordinary amount of complexity and confusion by containing various modifications to the meaning of associate entity under specific rules in Subdivision 820-AA. It is not clear how to resolve these modifications with the modification made to subsection 820-905(2B) which now applies various modifications to trusts and partnerships “for the purposes of Subdivision 820-AA”.
68. The provisions would benefit from a rewrite such that all the associate entity rules are contained within a single Subdivision (i.e. Subdivision 820-I) with each rule making an appropriate cross-reference to the specific test that is applicable rather than applying modification upon modification upon modification which can lead to confusion and uncertainty of outcomes.
69. Appendix B contains a number of technical items that we believe should be considered by the Board. We have also included our submissions on the third-party debt test in Appendix C and Appendix D. We have included some detailed examples below to help illustrate some of the key issues in further detail.

***Modification of associate interest (item 23 in Appendix B)***

70. We believe there may be technical errors in the modifications to the associate rules in subsection 820-905(2B) which may result in uncertain or unintended outcomes.

Example

71. *Y Unit Trust and Z Unit Trust are both Australian entities in which X Co owns 10% of the units. The other 90% of the units in both are held by parties unrelated to X Co and to each other with no single investor holding more than 10%. Z Unit Trust holds 100% of the shares in NZ Co, a CFC resident in New Zealand. Y Unit Trust has no investments in any foreign entity or branch and is required to consider if it is a general class investor. Neither unit trust is a public unit trust. The financial policies of the unit trusts are not influenced by X Co or any other single entity.*

### Analysis

72. Z Unit Trust is an Australian controller of an Australian controlled foreign entity in accordance with Item 1 in subsection 820-85(2). If it is assumed to be a financial entity, then it would be an outward investing financial entity (non-ADI) and therefore a general class investor.
73. Y Unit Trust would also be a general class investor pursuant to item 2 in subsection 820-85(2) if it is an associate entity of Z Unit Trust.
74. Neither Y Unit Trust nor Z Unit Trust hold any ownership interest in one another. However, they may be associate entities of each other under subsection 820-905(3A) if they are both associate entities of the same common entity, in this case, X Co.
75. Whether the unit trusts are associate entities of X Co depends on whether they apply a 10% test or a 50% test. Relevantly, in determining if one of the unit trusts is an associate entity of X Co, the unit trusts would need to be the “first entity” that that satisfies subsection 820-905(1).
76. Each unit trust is an associate of X Co under section 318 as X Co benefits under each trust as per paragraph 318(2)(c).
77. It then becomes necessary to considered whether a 10% or 50% associate interest test is to be applied for this purpose. That is, whether the 50% test in s 820-905(1)(a) is modified to be a 10% test under s 820-905(2B).
78. Section 820-85 is contained in Subdivision 820-B, which is not one of the purposes for which the s 820-905(2B) modifications are stated to apply. However, the definition of general class investor (which relies on the concepts in Subdivision 820-B) is contained in Subdivision 820-AA which is one of the purposes to which the s 820-905(2B) modification is stated to apply.
79. In our view, the 2024 amendments did not have a policy aim of expanding the scope of entities subject to Division 820. We believe that the added reference to Subdivision 820-AA in section 820-905 was an inadvertent error. Prior to that specific amendment, Y Unit Trust would not be considered an outward investment vehicle (general). Following the amendments, we believe it also should not be considered a general class investor and that section 820-905 should be amended to exclude the reference to Subdivision 820-AA.
80. We note that in other provisions of Subdivision 820-AA that there are specific modifications to the definition of associate entity (see sections 820-48, 820-52 and 820-54). It is arguable that the inclusion of these specific modifications in particular provisions should apply instead of the general modification in subsection 820-905(2B). Otherwise, the provisions would have inconsistent have conflicting modifications that cannot both hold. For example, where section 820-48 is applied to a trust, subsection 820-48(2) modifies the associate entity test to apply a TC control interest of 20%. This directly conflicts with subsection 820-905(2B) which applies a 10% associate interest test.
81. In our view, these specific modifications should clearly override the general modification in subsection 820-905(2B) which was introduced in 2019 to deal with a specific issue arising under the former balance sheet method involving structures with multiple trusts or partnerships and should not otherwise be extended to Subdivision 820-AA as a whole.

***Part-year rules (items 2, 3 and 4 in Appendix B)***

82. The predecessor thin capitalisation provisions contained part-year rules. Other than for tax consolidated groups, part-year rules were not included in the amended provisions. This can create anomalous or incorrect outcomes.

Example 1

83. *Aus Co is wholly owned by Australian entities and is acquired on 2 July 2024 by Foreign Co, a foreign entity. At all times during the period 2 July 2024 until 30 June 2025 Aus Co is a foreign controlled Australian company.*

Analysis

84. Aus Co considers if it is a general class investor for the 2025 income year. This requires that it be an inward investing financial entity (non-ADI) “for the income year” based on the assumption that it is a financial entity for all of the income year, in accordance with s 820-46(5). Item 1 in s 820-185(2) states that Aus Co would be an inward investing financial entity (non-ADI) for the period 2 July 2024 to 30 June 2025.
85. It is not clear whether Aus Co is a general investor for 2025 where it is not an inward investing entity for all of the income year (i.e. only 364 days out of 365).
86. This would depend on the interpretation of the phrase “for the income year” in s 820-46(2)(b) and whether this requires the entity to be an outward/inward investing entity for at least one day in the income year or whether the entity is required to be an outward/inward investing entity for every day in the income year.

Example 2

87. *Assume the same facts as the first example, except that Aus Co is acquired on COB 29 June 2025. It is a foreign controlled Australian company for one full day during the 2025 income year.*

Analysis

88. Again, it is unclear whether the provisions operate to treat Aus Co as a general class investor for the whole of the income year. The outcome under this second example should be the same as under example 1 as the wording of the provision is the same. In both cases, the interpretation would either be that Aus Co is a general class investor for the 2025 income year (based on it being an inward investing financial entity for at least one day of the year) or it is not (based on it not being an inward investing financial entity for that whole year).
89. Again, this would depend on the interpretation of the phrase “for the income year” in s 820-46(2)(b) and whether satisfying this for at least one day in the income year is sufficient or appropriate.

Example 3

*Aus Co, an Australian entity, establishes a wholly-owned subsidiary in New Zealand (NZ Co) on 2 July 2024. Aus Co is wholly owned by an Australian resident individual and neither it or any of its associates has a foreign subsidiary or branch other than its investment in NZ Co. The value of NZ Co is nominal and it remains dormant beyond 30 June 2025.*

#### Analysis

90. Assuming Aus Co is a general class investor, it considers whether it can apply the section 820-37 exception in the 2025 income year on the basis that the result of the formula in s 820-37(1)(c) is greater than 0.9. Under s 820-37(1)(a)(ii), Aus Co must be an outward investing entity “for all of” the 2025 income year.
91. Under item 1 of subsection 820-85(2), Aus Co would be an outward investing financial entity (non-ADI) for a period being some, but not all, of the income year being 2 July 2024 to 30 June 2025.
92. On a literal interpretation, Aus Co may only qualify for the s 820-37 exception in the 2026 year being the first year in which NZ Co could be a CFC of Aus Co for all of an income year.
93. This would be a different outcome than the provision prior to the 2024 amendments as the provision originally read:

*“Subdivision 820-B, 820-C, 820-D or 820-E does not apply to disallow any \*debt deduction of an entity for an income year if:*

*(a) the entity is an \*outward investing entity (non-ADI) or an \*outward investing entity (ADI) for a period that is all or any part of that year.” [emphasis added]*

94. This made it clear that being an outward investing entity at any time during an income year would be sufficient to qualify for the exception. Paragraph 2.140 to 2.141 of the EM suggests that section 820-37 was amended merely to update references to the new terminology and Subdivision rather than fundamentally changing what kinds of entities would be subject to Division 820. Accordingly, it would appear that the removal of the reference to “all or any part” is a drafting error that is inadvertently removing access to this exclusion.

#### Example 4

95. *Assume the same facts as the previous example, except that NZ Co was established before 1 July 2024 but is sold on 29 June 2025.*

#### Analysis

96. The outcome under this example should be the same as the previous one, as in both cases Aus Co was not an outward investing entity for all of the 2025 income year. However, there is technical uncertainty whether the exclusion should apply in this case. The example clearly demonstrates that the thin capitalisation provisions should not apply in these circumstances.

#### Example 5

97. *Assume the same facts as example 3 except that Aus Co and NZ Co were both established on 2 July 2024.*

#### Analysis

98. Again, this is just a variation of the facts. The outcome under this example may be the same as under the previous 2 examples, as Aus Co was not in existence for the entire income year and therefore may not have been an outward investing entity for all of the

2025 income year. Other provisions with the Act operate such that the start of the income year commences when an entity comes into existence. Without a part-year rule and without such a 'commencement' rule, this example gives rise to the same interpretive issue.

#### Example 6

99. *Assume the same facts as example 3 except that Aus Co and NZ Co were both deregistered on 29 June 2024.*

#### Analysis

100. The outcome under this example is likely to be the same as the previous, as Aus Co was not in existence for the entire income year and therefore may not have been an outward investing entity for all of the 2025 income year.

#### Example 7

*Assume the same facts as example 1 except that Aus Co is the head company of a tax consolidated group of which no other subsidiary member is a financial entity.*

#### Analysis

101. Section 820-583 states that Aus Co is a general class investor for part of the 2025 income year. This modification creates a number of anomalies. The first is that it creates some uncertainty as to the way in which the previous examples are to be interpreted. That is, if a modification is required by section 820-583, it may mean that the provisions otherwise only operate if the requirements are satisfied for a full income year.
102. Secondly, it is uncertain as to how the rules in Subdivision 820-AA should apply to Aus Co in the 2025 income year in this example. For example, is tax EBITDA calculated by excluding items that occurred on 1 July 2024 (i.e. a 364-day calculation) or is a taxpayer supposed to apportion its calculation by 364/365. This may be an interpretive issue for the ATO, but we raise this for completeness.

#### **Excess tax EBITDA (item 21 in Appendix B)**

103. Under section 820-60(4), the excess (unused) tax EBITDA of a trust can only be pushed up to 'controllers'. Where a controlled trust has no income (or a loss) for a year, the percentage control of unitholders in the trust may be considered to be nil because there is no income to which a beneficiary is entitled to acquire (the rules take the lower of the percentage rights to income or capital). If this is the case, then the provision may inadvertently not allow excess amounts to be taken into account in these cases.

#### Example

104. *Hold Trust owns 100% of Asset Trust, both of which are Australian resident unit trusts and general class investors. Neither trust elect to apply the group ratio test or third party debt test. Hold Trust obtained a loan to fund its investment in Asset Trust. Hold Trust incurs debt deductions and only receives income from trust distributions. Without an excess tax EBITDA amount, Hold Trust's tax EBITDA is nil. In the 2025 year, Asset Trust derives \$5,000,000 of gross trading income, incurs \$3,000,000 in deductible operating expenses and is entitled to \$4,000,000 of deductions under Divisions 40 and*

43. *Asset Trust makes an accounting loss and tax loss of \$2,000,000 for the 2025 year. Asset Trust's tax EBITDA is \$2,000,000.*

Analysis

105. Under the methodology in section 820-60, Hold Trust would have an excess tax EBITDA amount in respect of Asset Trust of \$2,000,000 multiplied by its TC direct control interest calculated using the assumptions in subsection 820-60(5). In order for Hold Trust to have an excess tax EBITDA of \$2,000,000 for the year, it would need to be the case that it holds a direct control interest in Asset Trust on each day of the 2025 year.
106. The TC direct control interest in a trust (under the modified section 351 of the ITAA 1936) is the lesser of the rights to income and corpus of the trust that the beneficiary is entitled to (or entitled to acquire).
107. In this example, which is a basic case with a single beneficiary, Hold Trust should have an excess tax EBITDA amount of \$2,000,000 for the year despite there being no distributions of income or capital for the year by Asset Trust. This could be supported by and interpretation that considers a TC direct control interest to exist based on rights to income or corpus that subsist with the unitholder at any given time (irrespective of whether there is income or capital) rather than requiring one to consider the percentage of distributions received in any given year.
108. In our view, it would be appropriate to conclude that at all times Hold Trust held a 100% TC direct control interest in Asset Trust and has an excess tax EBITDA of \$2,000,000 for the year. However, on the drafting of the provisions, there may be uncertainty whether this view is correct. We believe that this a clarificatory amendment should be made to ensure that this is the case.

***Third party debt test provisions (Appendix C and Appendix D)***

109. We have included in Appendix C of submission our detailed submissions in response to the Commissioner's draft taxation ruling TR 2024/D3 which covered aspects of the third party debt test ("TPDT").
110. We had also prepared a document highlighting the ambiguity in the Commissioner's practical compliance approaches regarding the application of the TPDT in Schedule 3 to PCG 2025/2. These highlight the areas of uncertainty that remain in applying the TPDT. We have included this in Appendix D.
111. Most of the issues we previously raised remain unresolved and our comments remain relevant for the Board in conducting the Review.
112. We highlight that many of the Commissioner's views would appear to be biased in favour of the revenue and unsustainable.

***Subparagraph 820-427A(3)(d) – Commercial activities***

113. A clear example of this is the ATO's approach to its interpretation of 'Australian asset'. Paragraph 95 of TR 2025/2 states that for a membership interest to be an Australian asset, it must be an interest in an Australian entity. Membership interests in foreign entities can never be Australian assets under this view which looks at form over substance.

114. Paragraph 96 then goes on to state that a membership interest in an Australian entity will only be considered an Australian asset using a 'look-through' test, adopting a substance over form approach.
115. These approaches seem contradictory and are unlikely to be sustainable. They highlight the need for legislative clarity on this key concept.
116. We also believe the view taken by the Commissioner in respect of the "commercial activities in connection with Australia" requirement<sup>13</sup> is not correct, is too restrictive and is unlikely to withstand judicial scrutiny. Paragraph 120 of TR 2015/2 states that "commercial activity can therefore be regarded as those acts or operations of trade or business capable of returning a profit."
117. The majority in the recent Full Federal Court decision in *FCT v Toowoomba Regional Council*<sup>14</sup> expressly rejected such an approach in considering the meaning of "commercial parking station" under FBT legislation:

*8. ... We are satisfied that the primary judge erred in the construction of a "commercial parking station" (PJ [35]). It does not require an intention to make, or to be aimed at, a profit-making purpose. In the relevant statutory context, as explained below, the meaning of "commercial" is being engaged in or in the nature of commerce.*

118. The ATO view is not consistent with the reason for introducing the test. The test was introduced in order to ensure that the 'activities' of the entity were connected with Australia. There was no intention for this test to restrict activities to a business. For example, if an investment fund holds a commercial property for rent (which may be regarded as a passive activity), there was no reason apparent on the face of the legislation that this type of entity would be excluded from having access to the TPDT just because it is not carrying on a business.
119. We believe the legislation should clarify whether this condition in the TPDT has its main emphasis on ensuring the test can only be satisfied for Australian activities (as opposed to activities outside Australia) or whether the emphasis is ensuring there are commercial/business activities (as opposed to non-commercial/non-business activities).
120. In our view, where all activities (whether active or passive) of the entity are domestic and all debt funding maintains its nexus with assessable income of that entity, this requirement should be satisfied. A simple exclusion could be tied to a nexus test. That is, the nexus would not be satisfied where debt deductions give rise to deductions under section 25-90 or (for non-corporate tax entities) debt deductions are incurred in deriving income from a foreign source.

Subparagraph 820-427A(5)(a)(i) – Credit support rights

121. We believe that there are two aspects of the exceptions to credit support rights prohibition that require clarity and we outlined these below.

*Meaning of "covered by subsection (4)"*

122. We are unclear as to the correct meaning of the phrase "covered by subsection (4)" in s 820-427A(4)(a)(i). In particular, whether the condition could be satisfied where the

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<sup>13</sup> Paragraph 820-427A(3)(d).

<sup>14</sup> [2026] FCAFC 50.

credit support right would allow for indirect recourse to Australian assets of an Australian entity that is not a member of the obligor group.

123. This is best illustrated by considering whether s 820-427A(5)(a)(i) would be satisfied in Example 6 in TR 2025/2. In that example Head Co is not a member of the obligor group as depicted in the diagram. Even though the credit support rights may only permit recourse to Australian assets of an Australian entity, on one interpretation this provision cannot be satisfied because Head Co is not a member of the obligor group such that Head Co's assets are not considered to be "covered by subsection (4)". The assets are neither assets held by "the entity", being Mid Trust, nor assets held by an Australian entity that is a member of Mid Trust's obligor group (i.e. Head Co it outside the obligor group).
124. This seems to result in an unfair outcome because it would prohibit indirect recourse to Australian assets of an Australian entity (via credit support rights) when direct recourse to those same assets would not be prohibited. This is because direct recourse would bring that entity (i.e. Head Co) within the obligor group and result in the recourse requirement in s 820-427A(3)(c)(i) being satisfied. The mere existence of a credit support right that does not expand the recourse net beyond what is normally allowed should not result in a failure of the third-party debt conditions.
125. A different interpretation is one that could treat Head Co's assets in example 6 as being "covered by subsection (4)" if you reconsider what "the entity" is when considering the particular credit support right. Under this view, Head Co could be considered to be "the entity" because there is recourse to its assets via the credit support right such that its assets are covered by subsection (4), in particular paragraph (4)(a).
126. TR 2025/2 seems to imply that this latter view is not correct. The modification of the obligor group example 19 to include Head Co seems to have been specifically done to demonstrate that Head Co needs to be a member of the obligor group in order for s 820-427A(5)(a)(i) to be satisfied in relation to the \$50 million bank loan.
127. Clarity around this issue would be welcome.

*Meaning of "that are not rights covered by this subsection"*

128. It is unclear as to the meaning of "that are not rights covered by this subsection" in the provision.
129. That is, it is unclear whether this means that s 820-427A(5)(a)(i) cannot be satisfied if the credit support rights provide recourse to ANY other credit support rights or only those that would NOT satisfy one of the concessions in subsection (5).
130. We believe that the phrase "that are not rights covered by this subsection" in s 820-427A(5)(a)(i) should be interpreted to refer only to exclude recourse to credit support rights that are prohibited (i.e. the ones that do not meet the exceptions), rather than any credit support rights whatsoever. That is, back-to-back credit support rights are permissible if the exercise of those next credit support rights in the chain would also satisfy one of the exceptions. However, paragraph 142 of TR 2025/2 is unclear on this point as it states that the credit support rights cannot provide recourse "to other credit support rights", rather than only other prohibited credit support rights.
131. Clarity around this issue would be welcome.

**Item 3: If the \$2 million exemption threshold should operate as a net debt deduction concept**

Net debt deductions and the exclusion threshold

132. We believe that after the introduction of the net debt deduction concept, the \$2 million *de minimis* in section 820-35 should also be based on net debt deductions.
133. As outlined in a 2014 Explanatory Memorandum,<sup>15</sup> the *de minimis* rule exists to “reduce compliance costs and ensure that small businesses are protected from the effects of the thin capitalisation debt tests”.
134. We highlight that the new thin capitalisation measures have a significantly high compliance cost for taxpayers in the middle market. They require taxpayers to apply highly complex rules in order to determine whether the provisions apply in the first place including the application of the complex associate and associate entity rules and exclusion provisions. Applying the tests, undertaking the required calculations and considering the elective methods add further complexity and cost.
135. In addition, applying the DDCR places an extraordinary burden for taxpayers in the middle market to apply, particularly where groups are unconsolidated and the use of intra-group financing is commonplace.
136. We believe that the majority of taxpayers in the middle market will not be able to rely on their regular tax agent to determine whether the provisions apply or not and will need to seek assistance from specialist tax advisors, at a significant cost. Accordingly, we believe that there needs to be an appropriate balance between integrity and cost to revenue regarding the use of excessive debt in Australia, and compliance costs for taxpayers.
- 136.1. By way of example, if a taxpayer is required to apply the FRT and had \$2.1 million of debt deductions, but also derives \$2 million of interest income during an income year, the maximum net debt deductions that can be denied under the new rules is \$100,000. Previously the entire \$2.1 million was subject to denial under the rules.
- 136.2. As net debt deductions are only \$100,000, the taxpayer should be excluded from cost of complying with the provisions due to the minimal risk to revenue. This outcome strikes an appropriate balance between integrity and compliance costs.
137. In this example, without a *de minimis* rule, the relevant taxpayer would be required to undertake all of the compliance activity associated with determining whether: (1) the entity is subject to the thin capitalisation rules; (2) in applying the rules and correctly completing all associated tax return disclosures; and (3) applying the DDCR and completing all the necessary disclosures relating to that. This is the case even though the amount of net debt deductions that is now subject to denial is significantly well below the *de minimis* threshold (i.e. \$100,000 in the example).

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<sup>15</sup> Tax and Superannuation Laws Amendment (2014 Measures No. 4) Bill 2014.

138. Furthermore, the \$2 million threshold has not been indexed in 12 years and may no longer be an appropriate *de minimis* in an environment of increasing costs and interest rates.
139. Adopting a \$2 million *de minimis* based on the 'net debt deduction' concept strikes an appropriate balance for small taxpayers in the middle market that are generally not tax consolidated. Using a gross basis (rather than a net basis) means that intra-group lending can result in double counting the same debt deduction<sup>16</sup> under the existing *de minimis* rule unless the provision changes to a net debt deduction test. As noted earlier, this places non-tax consolidated groups at a disadvantage where intra-group debt is not otherwise ignored.
140. As 'associate entity' deductions are counted for the purpose of that test, we highlight that any debt deductions claimed by an associate would be counted thus providing integrity on a group basis.
- 140.1. Example 1: Assume there are two taxpayers in the Group (A and B) and that Taxpayer A borrows \$30 million externally and incurs interest expenses of \$1.5 million (at 5% interest). Assume that Taxpayer A on-lends \$20 million to Taxpayer B and receives \$1 million in interest income. Assume both taxpayers are general class investors and would be able to apply the FRT. In this example, Taxpayer A would have net debt deductions of \$0.5 million and Taxpayer B would have net debt deductions of \$1 million. On a group basis, the total net debt deductions would be \$1.5 million and would be under the current limit of \$2 million. We believe that this is the correct result on a group basis. Without an amendment, gross deductions would be \$2.5 million and both these taxpayers would be subject to the thin capitalisation provisions.
- 140.2. Example 2: Assume the same facts, however Taxpayer A borrows \$30 million from a financier and incurs interest expenses of \$2.1 million (at 7% interest). Assume that Taxpayer A on-lends \$20m to Taxpayer B and receives \$1.4 million in interest income. Assume both taxpayers are general class investors and are able to apply the FRT. In this example, Taxpayer A would have net debt deductions of \$0.7 million and Taxpayer B would have net debt deductions of \$1.4 million. On a group basis, the taxpayers would have net debt deductions of \$2.1 million (\$0.7 million + \$1.4 million) and would be over the current limit of \$2.0 million. Again, we believe that the provisions (using an associate entity grouping concept) would automatically provide appropriate integrity on a group basis.
141. We believe that this amendment would be relatively simple to implement and would retain the status quo for middle market taxpayers under the new methods, would provide integrity to the provisions on a group basis, and would appropriately reduce unwarranted significant compliance costs as a result of changing to the new methods.
142. We note that adopting such a rule would also provide relief provided to larger taxpayers with significantly greater amounts of debt. For example, it will provide an exemption to a large tax consolidated group with \$1 billion in debt deductions for the year if it has \$998.1 million of interest income during that year.
143. However, this example should not give rise to an integrity concern. No matter how large gross debt deductions are, it is only ever the net debt deductions that are at risk under

<sup>16</sup> The conduit financing rules in section 820-427C recognise that many non-tax consolidated groups have a 'group treasury' entity to streamline and simplify borrowing processes for the group. Many groups also use the entity with the best access to funding to borrow money and on-lend to other group members as required.

the FRT. The example demonstrates that the interest income is derived from a non-associate entity. Accordingly, the group as a whole is effectively only deducting less than \$2 million of net debt deductions.

144. If that taxpayer had instead \$1.001 billion in interest income that year, their net debt deductions would be negative, and no amounts could be denied in any case.

#### DDCR exclusion

145. An exclusion from the DDCR is also appropriate in this case where debt deductions does not exceed \$2 million. As outlined earlier, we believe that the DDCR was inserted to provide integrity to support the existing thin capitalisation rules and to prohibit the use excessive debt in Australia. Where there is minimal revenue at risk under the default FRT (i.e. due to net debt deductions being below the *de minimis*) there would be little or no justification in requiring the DDCR to act as an integrity measure.
146. However, if the *de minimis* is to operate based on a net debt deduction concept, we highlight that thought may need to be given to appropriateness of an associate entity-inclusive rule for DDCR purposes.
147. For transparency, while we believe that it is appropriate to extend section 820-35 to the core thin capitalisation provisions, we acknowledge that there may be issues that would need to be considered before extending a 'net debt deduction' *de minimis* rule to the DDCR provisions. This is demonstrated by the following examples.
  - 147.1. Example 3: Taxpayer X has \$248.1 million of interest income and its associate entity Taxpayer Y has \$250 million of interest expenses for the year. Under the current rules there is \$250 million of debt deductions at risk and subject to denial under the FRT and DDCR.
148. If no amount of the interest expense is paid to a non-resident associate (either directly, or via a trust distribution subject to withholding tax), then we believe that the example above would not give rise to integrity risks. However, to the extent that this has resulted from 'debt dumping' such that additional Australian debt has been created, which is paid to non-residents, then we understand that this could cause an integrity concern. That being said, we note that if, in Example 3, the two entities were members of a tax consolidated group, the exclusion in section 820-35 could apply if a net debt deduction test was adopted.
149. After considering this issue, the BOT may consider that allowing the \$2 million *de minimis* in these circumstances may not be justified. We would appreciate being able to consult with the Board on this issue further. To the extent that there are cases where it is not justified, then we note that additional integrity could be provided in such cases by treating a negative amount of net debt deductions (i.e. where interest income exceeds interest expenses) as nil for these purposes. This would ensure that the *de minimis* exemption is only available to groups that would otherwise have no more than \$2 million of debt deductions that could possibly be denied under the default tests so as to justify an exemption from the high cost of compliance and administration. This is demonstrated by Example 1 and Example 2 above which shows how a net debt deduction *de minimis* rule would work on an entity-by-entity basis.

**Item 4: Whether the default tax EBITDA calculation operates to appropriately reflect an entity's economic activity in the income year and across multiple income years, as intended**

150. Whether tax EBITDA is precisely the correct measure to reflect economic activity or whether 30% of tax EBITDA is an appropriate limit, is difficult to say with certainty. We believe that this is difficult to answer as taxation advisors.
151. That being said, we outline a number of issues with the current tax EBITDA calculation that may prevent it from working as intended.

***Treatment of losses – character of amounts***

152. The original exposure draft of the rules defined tax EBITDA in a way that added back prior year tax losses deducted in the income year.<sup>17</sup> Therefore, only the activities in the current year were considered relevant.
153. This would have resulted in somewhat favourable outcome for taxpayers as this could allow for a greater FRT limit amount in profitable years, even though over the life of the entity there may be little to no overall tax EBITDA.
154. When the Amending Act was introduced into Parliament, the add back for tax losses was removed from the definition of tax EBITDA. Rather than removing the favourable outcome for taxpayers, the change overcorrected. This has resulted in changes that are, in many cases, unfair to taxpayers.
155. The reduction for tax losses deducted during the year does not account for the fact that those tax losses may be comprised of net debt deductions, capital allowances and certain partnership losses that would otherwise be added back if the amounts all arose in the one income year. This can lead to arbitrary outcomes.
- 155.1. Example 1 – Company A incurs \$1,000 of net operating losses (excluding depreciation) and is able to deduct \$500 of capital allowances under Division 40. It makes a tax loss of \$1,500 in year 1. In the following year, the company makes \$1,500 of net operating profits and has another \$500 of deductible capital allowances. After adding back the \$500 of capital allowances in year 2 and deducting its \$1,500 tax loss 2, its tax EBITDA is nil (i.e. \$1,000 + \$500 - \$1,500).
- 155.2. Company A would therefore not be able to deduct any net debt deductions in year 2 if it had debt. This is despite the carry forward losses being comprised of capital allowance deductions.
- 155.3. If instead all amounts arose in the same year, its tax EBITDA would be \$500 (i.e. representing the overall net taxable operating profits over the two years).
156. As outlined above, the \$500 difference in the above example arises because the tax depreciation loses its character once it becomes a tax loss and deducted in a subsequent year.

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<sup>17</sup> <https://treasury.gov.au/sites/default/files/2023-03/c2023-370776-ed.pdf> - Refer to the draft paragraph 820-49(d).

157. In order to provide a perfect outcome, tax losses would need to be tracked in its character. We acknowledge that this would add significant complexity as well as potentially arbitrary rules to determine which part of a tax losses represents prior year interest or depreciation.
158. Alternatively, we believe the appropriate solution is one that allows the tax losses to be added back, with an additional adjustment to reduce tax EBITDA by prior year negative EBITDA amounts. This could effectively allow the 30% tax EBITDA amount to be the appropriate measure over time without undermining the 15-year carry forward limit or the policy choice of not allowing carry back of excess amounts.
  - 158.1. Continuing on from Example 1, this proposed change would result in Company A having negative tax EBITDA of \$1,000 at the end of year 1. When undertaking its calculation in year 2, Company A adds back its \$1,500 tax loss and instead subtracts its \$1,000 prior year tax EBITDA. This results in a tax EBITDA in year 2 of \$500 ( $\$1,000 + \$500 - \$1,000$ ) which represents a fair outcome.
159. This proposed solution does not address transitional issues such as pre-1 July 2023 tax losses. However, at the very minimum, we believe that this proposed alternative method should give rise to equitable outcomes on a go forward basis.
160. It may also be appropriate for carry forward negative tax EBITDA amounts to drop away after 15 years to achieve consistency with the 15-year carry forward rule for FRT disallowed amounts.

***Treatment of losses – carry forward loss treatment***

161. The current rules also seem to produce the following arbitrary outcome where there are tax losses. In some cases, this can result in a favourable outcome for taxpayers.
  - 161.1. Example – Company B makes an operating loss of \$10,000 in year 1 and carries this forward as a tax loss. In year 2, Company B makes a \$1,000 operating profit and has \$500 of debt deductions. Company B calculates its tax EBITDA as \$500 in year 2 (i.e. \$500 current year taxable income less \$500 prior year tax loss plus \$500 net debt deductions). Company B can deduct \$150 under the FRT method in year 2 and has \$350 of debt deductions disallowed. This reduces its current year taxable income to \$350.
  - 161.2. Company B then deducts a further \$350 of prior year tax losses in addition to the initial \$500 deducted. Company B's economic loss over 2 years of \$9,500 is reflected in \$9,150 of tax losses and \$350 of FRT disallowed amounts.
  - 161.3. If the amounts in the above example all arose in the same year it would have a tax EBITDA of -\$9,000 and no debt deductions allowed. It would have a \$9,000 tax loss and \$500 of disallowed FRT amounts.
162. By limiting the amount of a tax loss deducted to the current year taxable income and then adding back net debt deductions from a base of nil (rather than from a negative base), the tax EBITDA calculation converts what may otherwise be a carry forward FRT disallowed amount into a tax loss which may more easily be utilised.
163. If, in the above example, our proposed solution was instead adopted, Company B would carry forward a negative tax EBITDA of \$10,000 from year 1 to year 2 (but

disregard the deduction for tax losses), it would have a tax EBITDA of -\$9,000 in year 2 and result in the appropriate outcome of \$500 of FRT disallowed amounts.

164. This methodology would seem to eliminate arbitrary outcomes that both favourable and unfavourable for taxpayers.

***Debt deductions at partnership level***

165. The tax EBITDA calculation allows the entity which had FRT disallowed amounts to carry them forward to later years, including partnerships. It does not attribute the amount to the relevant partners.
166. Besides a lack of any continuity of ownership type testing rule for partnerships, there is a further distinct advantage that partnerships have where they are in a tax loss position. Because those partnership tax losses flow through to the partners, they do not act to reduce tax EBITDA in future years in the same way they do for companies and trusts. This is demonstrated with the following examples.
- 166.1. Example 1 – In year 1, Partnership X incurred net operating losses of \$1,000 and incurred \$500 of debt deductions. Under the FRT method, its FRT limit was nil and its debt deductions were denied in full. The Partnership made a \$1,000 loss which flowed through to its partners in full and had \$500 of FRT disallowed amounts. In year 2, the Partnership made \$2,000 of net operating profits and incurred \$100 of debt deductions. In year 2, its tax EBITDA is \$2,000 and its FRT limit is \$600. The Partnership deducts \$100 of current year debt deductions and has an excess of \$500 allowing it to deduct a further \$500 of FRT disallowed from the prior year under section 820-56.
- 166.2. Overall, Partnership X had made \$1,000 of taxable net operating profits and was able to deduct \$600 of net debt deductions over two years. This allows an effective FRT limit of 60% of tax EBITDA when looking at the total period.
- 166.3. By contrast, a company in the same position would have tax EBITDA of only \$1,000 in year 2 because it applies its carry forward tax losses to reduce its tax EBITDA for that year. This would result in only \$200 of FRT disallowed amounts being deductible in year 2 and \$300 overall in respect of taxable net operating profits of \$1,000 over the two years.
- 166.4. Example 2 – Assume the same facts as example 1 but partnership X had \$99,000 of net operating losses in year 1 and \$100,000 of net operating profits in year 2. Tax EBITDA in year 2 would be \$100,000 resulting in an FRT limit of \$30,000 that year. This effectively allows the partnership to deduct \$30,000 of net debt deductions against \$1,000 of net taxable operating profits over the period, representing an effective FRT limit of 3,000% of tax EBITDA over the period.
167. A flow-through rule for partnerships of tax EBITDA and net debt deductions amounts may therefore be more appropriate than the current rules which require calculations at the partnership level and attribution of excess amounts to certain partners under section 820-60. However, we understand that this alternative may not be perfect (as it would require EBITDA calcs to be carried out by small (e.g. 1%) partners). Accordingly, the Board may wish to consider whether this method is appropriate as part of its review.

### ***Unfair excess tax EBITDA rules***

168. As outlined above in our comments regarding consolidated vs non-consolidated groups, the tax EBITDA calculation can produce arbitrary outcomes which do not reflect overall economic activity. This can arise where entities are unable to receive excess tax EBITDA amounts (such as discretionary trusts, individuals, and those who hold an interest of less than 50% in another entity).
169. Additionally, as we also outlined earlier in our comments for Item 1, the inability to attribute an excess where net debt deductions are negative also leads to inappropriate outcomes not reflective of the broader group's overall debt levels.

### ***No carry back of excess capacity***

170. The rules allow for carry forward of FRT disallowed amounts only, but not a carry back. This may result in unfavourable outcomes for entities with trailing debt deductions that continue to be incurred after the main operating activities have ceased.
171. This appears to be a deliberate policy choice consistent with the manner in which tax and capital losses can be utilised.
172. However, following the May 2026 Budget which provided for a permanent loss carry-back for certain companies, we believe thought could be given to allowing a limited form of excess tax EBITDA carry back to allow current year debt deductions to be deductible, which may either then give rise to a loss carry-back tax offset or a carry forward tax loss.
173. Such relief could be provided to the same class of entities (i.e. those with aggregated turnover of less than \$1 billion) and for the same carry-back period (i.e. two income years).

### ***Tax depreciation for small business entities***

174. Paragraph 820-52(1)(c)(ii) only allows entities to add back capital allowance deductions under Divisions 40 and 43. Small business entities claim tax depreciation under Subdivision 328-D.
175. Additionally, entities that are no longer small business entities (whether their business has grown or whether they have been acquired by a larger group) still maintain their general small business pool<sup>18</sup> and continue to claim deductions under that Subdivision rather than Division 40.
176. Omitting depreciation deductions for these entities produces less favourable outcomes as compared to larger groups. The tax EBITDA calculation should be updated to allow depreciation for small business entities to be added back.
177. Whether amounts deducted in full in the year incurred under the instant asset write-off should be allowed to be added back may be a question of policy and whether such amounts should be allowed to be added back as a concession.

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<sup>18</sup> See the note to subsection 328-175(1).

### ***Tax depreciation for R&D entities***

178. Subsection 820-52(10) subtracts an R&D entity's notional deductions from its tax EBITDA to overcome the technical problem of such amounts counting towards a tax offset and not actually reducing taxable income due to section 355-105.
179. However, to the extent that that such notional deductions represent the decline in value of depreciating assets under Subdivision 355-E, we note that they should be added back to achieve consistency of treatment with non-R&D entities.

### **Item 5: The practical impact on the cost of complying with the debt deduction creation rules after restructures, including whether the rules have effectively discouraged debt creation schemes**

180. As outlined earlier in our submission, we believe that the DDCR is currently not fit for purpose and needs to be reconsidered wholesale.
181. Rather than discouraging debt deduction creation schemes, their main effect has been to make taxpayers question whether their ordinary pre-existing arrangements have accidentally been caught by the rules, forced taxpayers to trace historic loans in some cases going back decades and just generally created a significant amount of uncertainty regarding the application of the rules.
182. We believe that the DDCR should not have applied to historical arrangements. These examples present little or no mischief and have become impossible for taxpayers to evidence. Furthermore, we reiterate that the DDCR should not generally apply to wholly domestic arrangements. Only where arrangements are entered into to manipulate thin capitalisation outcomes (i.e. under the FRT) between domestic entities, should the DDCR apply to domestic schemes. Further, we reiterate that DDCR should not apply where the section 820-37 exemption applies.
183. The DDCR should not have automatic application to certain transactions and should only apply where a scheme is entered into for a purpose (whether dominant or non-incident) of obtaining excessive debt deductions in Australia.
184. Currently, there is a risk that the DDCR is able to be applied to far too many benign situations. Further, where a taxpayer is unable to trace the historic origins of every loan, including loans that were refinanced by current loans, the Commissioner has indicated at paragraph 160 of PCG 2025/2 that failure to prove a negative is likely to attract the allocation of compliance resources by the Commissioner.
185. The impracticality of tracing specific dollars to specific uses is the main issue regarding the DDCR. For complex private groups where funds are constantly flowing throughout the group, we believe that the provisions are so complex that it is near impossible to conclude on the application of the provisions with any degree of certainty. We believe that no two people armed with the same information would come to the same conclusion regarding the application of DDCR in situations where there has been some related-party financing as well as some relating party payments or acquisitions.
186. Further, the nexus rules contained in section 820-423A are too uncertain, and the indirect rules contained in subsection (3A) and (7) are too unclear. In most real-life scenarios, it is too difficult to determine when a debt deduction "relates" to something, when financial arrangements "fund" something or when they "facilitate the funding of" something without funding that something. These loose tests make it unclear what

kinds of payments can be used to trace indirectly and what the temporal limits are in undertaking such tracing.

187. We make comment on these issues in further detail below.

### ***IDS compliance***

188. The current compliance requirements relating to the DDCR are far too extensive. Not every integrity rule warrants multiple pages of questions on a tax return or International Dealings Schedule (“IDS”).
189. Questions 54 and 55 of the IDS ask an entity to question if they have in a prior income year made an acquisition from an associate or made a certain payment or distribution to an associate. This essentially asks the taxpayer to determine if they have ever entered into a contract with a related party, made loans or subscribed for equity in a related party or ever pay a dividend or trust distribution. This may have occurred in 1975 and the taxpayer would be required to answer yes. Such an answer can provide no sensible information to the ATO.
190. Question 56 and 57 then go on to repeat the same questions but for current year acquisitions or payments/distributions.
191. Question 58 then requires disclosures relating to debt deduction denied for an entity that did not make the relevant acquisition or payment but is an associate of such an entity. We do not believe most taxpayers will even understand when question 58 applies let alone be able to confidently complete that question. Despite that, the disclosures required in question 58 include details of the associate including their country code. None of the provisions turn on the location of an associate and we question the necessity of such disclosures.
192. We have also been made aware that there is no country code for Australia if one is intending to disclose a domestic arrangement. Instead, the ATO have requested that the country code for Antarctica to be used as a way to indicate Australia.
193. In our opinion, the whole of Section H of the IDS could be replaced with two or three simple questions asking whether any type 1 or type 2 transactions have occurred in the current year and whether (and the extent of) any debt deductions related to these items.

### ***Application to transactions before commencement and becoming subject to the DDCR***

194. The old debt deduction creation rules in former Division 16G of Part III of the *Income Tax Assessment Act 1936* (“ITAA36”) only applied to acquisitions of assets that occurred on or after 1 July 1987.<sup>19</sup> The proposed DDCR are not limited in this way. Therefore, they may apply in respect of assets that were acquired before the rules commence, and perversely, to asset acquisitions that occurred before 1 July 1987.
195. In addition to an unfair retrospective application of the rules, taxpayers who are not ultimately subject to a denial of debt deductions would still face high compliance costs to prove that the DDCR rules do not apply to their arrangements. Taxpayers with any related party debt deductions will have to consider the historical ownership of all of their assets and determine if they were acquired from an associate. Because of the

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<sup>19</sup> See former section 159GZZD(b) of ITAA36.

application of the rule to indirect acquisitions (e.g. via one or more interposed entities), this can greatly expand the inquiry. In many cases there may not even be a real indirect acquisition or distribution (however, due to the breadth of the indirect rule, there may be deemed acquisitions or distributions). Such related party acquisitions or distributions may have occurred within tax consolidated groups or may have been benign transactions such as restructures pursuant to CGT roll-overs. Costs to comply with the rules are inevitably borne disproportionately by private groups who may need to seek specialist tax advice. Further, information may not be readily available for transactions occurring many years prior.

196. The DDCR also imposes current obligations on entities who are not subject to the rules but may become subject to the rules in the future (e.g. where their business and level of debt deductions grows and/or they begin to expand offshore). The first year that any entity becomes subject to the rules may require them to consider all their historic arrangements which could suddenly result in debt deductions being denied. This is because there is no grandfathering for entities that become subject to the rules at a later time. This can be contrasted with, for example, the Taxation of Financial Arrangement rules which only apply to financial arrangements that entities start to have after they meet the relevant thresholds.
197. Ultimately, it is somewhat absurd that the DDCR can apply to transactions entered into before the former Division 16G commenced, let alone ended (even where Division 16G would not apply to the same arrangement).

***Temporal aspects are unclear***

198. The rules are not sufficiently clear as to when certain elements are required to be tested. For example, the asset acquisition rule in proposed subsection 820-423A(2) requires an asset (or obligation) acquisition from an associate as well as a debt deduction for an amount paid to an associate. However, it is not clear when the associate relationships are tested.
199. For example, Entity A may have acquired an asset from Entity B at a time when they were associates, with the acquisition funded by third party debt. Years later, Entity A is acquired by Entity C who refinances that debt. Entity B is not acquired under this transaction and now becomes an unrelated party to Entity A and continues to be unrelated to Entity A when the debt deductions for amounts paid to Entity C are incurred.
200. If the DDCR can apply to such transactions, it may cause unintended outcomes that impact M&A activity. In any case, the actual operation of the rules as currently drafted are not entirely clear and will lead to disputes between taxpayers and the ATO. These aspects need to be clarified with all implications thought through carefully.

***The indirect rule is far too broad and uncertain***

201. The DDCR can apply to indirect payments and acquisitions made through interposed entities (as contained in subsections 820-423A(3A) and (7)). However, the mechanism used is one that links two transactions that are otherwise not connected in any meaningful way. That is, a “sufficient if they exist” and “not necessary to demonstrate that one funded the other” test is adopted.
202. This is a mechanism adopted from the imported hybrid mismatch rules in Subdivision 832-H. The compliance obligations imposed to comply with such a broad rule are

extraordinary. Refer to PCG 2021/5 which outlines the ATO's expectations of taxpayers to obtain the information needed to comply with a rule of this kind.

203. This broad approach to indirect payments and acquisitions further compounds the complexities outlined above in respect of the unclear temporal aspects of the rules.
204. Fundamentally, this is the wrong approach to an integrity rule that is targeted at certain schemes that are artificial or lack commercial justification. The denial of a debt deduction for a related party borrowing because of a completely unrelated transaction occurring between entities multiple steps removed from the borrowing (which was demonstrably used for a completely different purpose) is antithetical to the rules.
205. Instead of this broad approach, an approach to an 'indirect rule' that requires two or more transactions to be linked in some coherent way would be more appropriate. An example of this is the reasonable person test contained in the Division 7A rules (e.g. section 109T of ITAA36).
206. Currently the rules have both a nexus test in s 820-423A(2)(d) (i.e. the debt deduction needs to be "in relation to" an acquisition or holding) and s 820-423A(5)(d) (i.e. the debt deduction must be "in relation to" the relevant financial arrangement that funded or facilitated the funding of the relevant payment or distribution).
207. At the same time as having a nexus test, the indirect rules adopt a "sufficient if they exist" rule which requires no nexus whatsoever between two transactions. It is fundamentally incoherent to have both a nexus test and a test that disregards nexus entirely. If there must be a nexus, it is not clear how there can ever be a nexus to an indirect payment, distribution or acquisition that is simply deemed to occur because the mere existence of two or more things.
208. For example, Fin Co borrows from related party A Co to lend to B Co in order to fund working capital expenses (e.g. salaries and overheads). B Co also raised equity to fund a related-party asset acquisition from C Co three years later. There may be a deemed indirect acquisition by A Co to C Co under the indirect rules (as the rule link two acquisitions merely because they both exist). However, A Co's debt deductions are in no way related to that asset acquisition transaction in this example.
209. Further, there is no temporal limits placed on the indirect rule in ss 820-423A(3A)(b) and (7). By contrast, the importing payment rule in section 832-625 which seemed to be the model for the section 820-423A "sufficient if they exist" rule has a clear rule outlining the period within which an offshore hybrid mismatch can be imported.<sup>20</sup> This allows taxpayers to understand the period for which transactions should be tested to work out if there is a deduction that is to be denied that income year. Under the DDCR, a loan made to an entity in 1990 is deemed to result in an indirect acquisition by the lender in 2030 if the borrower acquires an asset (using any source of funding) 40 years later.
210. A more sensible and coherent approach needs to be adopted in applying the rules to indirect transactions.
211. If DDCR contained an objective purpose requirement, as we suggest, there would need to be a coherent scheme in order for the provision to apply.

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<sup>20</sup> Refer to subsection 832-625(2).

212. Additionally, it is not clear the kinds of payments that can be used to create a connection between two entities for the purposes of the indirect rule. For example, for distributions, does every link in the chain need to be a distribution (or one of the kinds of prescribed payments in subsection 820-423A(5A)) or can one of the payments be a payment for services or a loan repayment, etc.
213. There is also uncertainty about the scope of application of rules where the relevant entity is not the acquirer mentioned in subsection 820-423A(2) or payer mentioned in 820-423A(5). The rules can extend to where the 'relevant entity' (i.e. the entity whose debt deductions are ultimately denied) is not the payer or acquirer but is an associate pair of the acquirer (or disposer) or associate pair of the payer (or recipient).
214. This extension suggests that it may cover an entity the situation where one entity borrows money and incurs debt deductions, where some other related party makes the acquisition, payment or distribution. For the rule to work in this situation there must presumably be some nexus or relation between those debt deductions and the relevant transaction. If such a nexus exists, presumably some form of payment would have to be made by the borrower to the entity that made the acquisition, payment or distribution. If so, it is not clear why the indirect rules would not already apply and what purpose the extension to acquisitions, payments and distributions by associates achieves. Further, determining whether this has occurred is near impossible in most cases.
215. The law needs clarity on how these provisions work together coherently in order for their scope to properly be understood.

#### ***Potential for multiple taxation and section 820-37 interaction with conduit financing***

216. If A Co lends to B Co which lends to C Co which makes a distribution to an associate pair, both B Co's and C Co's debt deductions would appear to be permanently denied.
217. There is no rule which switches off further tracing once the first borrower in a chain of entities has their debt deductions denied under the DDCR.
218. We note that such back-to-back financing arrangements may be within scope of the conduit financing rules allowing the entities to choose to apply the TPDT and benefit from the exclusion to the DDCR.
219. However, it could be the case that the entities involving in the arrangement are subject to the exclusion from Division 820 in section 820-37. The Commissioner's approved form for making a TPDT choice expressly prohibits such entities from making a choice to apply the TPDT. Therefore, such entities are at a distinct disadvantage from entities that do not fall within section 820-37 as they cannot make a choice that would have the effect of excluding them from the DDCR in respect of the exactly same kind of transaction, being one which would meet all the necessary third party debt conditions.

#### ***Exclusions in former Division 16G should be maintained***

220. Former Division 16G had sensible exclusions for acquisitions of trading stock as well as arrangements that do not result in any net increase in Australian debt (e.g. where debt is used to pay down other existing debt). Further, the exclusion in proposed section 820-423AA for the acquisition of new membership interests in entities applies to companies where the entity is a foreign entity but does not apply to acquisitions of membership interests in foreign trusts or foreign partnerships.

221. The exclusion should be expanded to cover such acquisitions as these are less likely to pose a risk to the tax base since the taxable net incomes of foreign trusts and partnerships generally flow through to Australian members on an annual basis. By comparison, the profits of foreign company subsidiaries may be accumulated and (subject to the CFC rules) result in Australian tax being deferred until a dividend is paid.
222. Such exclusions should be considered to ensure the rules are appropriately targeted and do not prevent business from entering into ordinary commercial transactions.

***Application to ‘acquisition of obligations’ is unclear***

223. The rule in proposed subsection 820-423A(2) applies to acquisitions of CGT assets as well as legal or equitable obligations. It is not immediately apparent how an entity’s debt deductions can relate to the acquisition of an obligation. Normally debt deductions relate to asset acquisitions because borrowed funds are used to fund the acquisition of an asset. Generally, one does not borrow to fund the acquisition of an obligation. Instead, the obligation may be acquired in order to reduce the price otherwise payable for an asset.
224. If one acquires an obligation merely by borrowing money, then any interest on those borrowings would seem to have the necessary relation to that acquisition. On this view, all related-party debt is caught by the DDCR no matter what the borrowings are used for. This cannot sensibly be the correct view, but it is one that is open on a literal interpretation.
225. Additionally, it is not apparent if an entity is even able to “acquire” an obligation under the meaning of that term in section 995-1. The meaning of “acquire” is defined in a way that only relates to CGT assets. If an obligation is acquired merely by borrowing money, then this could make the application of the rules unnecessarily broad particularly in conjunction with the overly broad interposed entity rules. For example, many private groups that are not consolidated for tax purposes have complex financing arrangements involving many loans and unpaid present entitlements to trust income. Trying to comply with the DDCR by tracing through potentially an enormous number of possible chains of payments and obligations would be highly complex.
226. The application of the DDCR to the acquisition of obligations needs to be properly explained and reconsidered.

***Lack of clarity regarding services and royalties***

227. Related party services are generally performed under a contract. When such parties enter into a contract, they each acquire contractual rights (i.e. CGT assets) from one another.
228. While services do not seem to be the subject of the DDCR, there is a risk that the related party acquisition rule under subsection 820-423A(2) can apply where payments for services are funded by related-party debt.
229. On one view, the entity continues to hold contractual rights and there may be seen to be a nexus to this ongoing holding. On another view, the borrowings are used to pay for the performance of the contract rather than its acquisition or ongoing holding.
230. It is common for property developer groups to have a developer entity to provide services to a landholding entity. This could involve both the provision of parts and

labour. It should be clarified that this sort of agreement is not usually one that would be considered to result in the acquisition of assets from the developer. Even if the developer was not acting as an agent in respect of the parts or materials, we believe the better view is that the landowner is not acquiring assets from an entity (e.g. bricks, planks of wood, etc) but rather than these assets are being added to and merging with the land as they are being affixed to it, rather than the landowner being considered to acquire such assets in their own right, as standalone assets. This may not be the case for certain depreciating assets which may be considered separate assets in their own right, but the exclusion in section 820-423AA may be relevant for these.

231. The definition of royalty in the ITAA36 includes both the use of industrial, commercial or scientific equipment (which excludes rent from an interest in land or fixtures) and the supply of scientific, technical, industrial or commercial knowledge or information. This could potentially cover the leasing of ordinary depreciating assets. Additionally, the extension to “similar payments” for the use of, or right to use, an asset in s 820-423A(5A)(f) and then to a payment of a kind similar to a payment mentioned earlier (i.e. a payment of a kind similar to a payment that is similar to royalty) makes the scope of the rule far too uncertain.
232. Due to the potential breadth of the provisions, there are competing arguments as to the proper application of the DDCR. Such lack of clarity should be addressed so that the scope of the rule can clearly be understood.

***Potential application of the ‘payment or distribution’ rule to ordinary trust arrangements***

233. The rule in proposed subsection 820-423A(5) applies to payments and distributions covered in subsection 820-423(5A) which includes distributions by trusts and payments or distributions of a similar kind.
234. We highlight that the risk of artificial debt creation is not present in the case of a trust that is compelled to make annual distributions of income in the same way as a dividend or return of capital by a company or a capital distribution by a trust that is generally at the discretion of the entity. In our view, it is inappropriate to extend the DDCR to distributions of income by trusts. In particular, all distributions by discretionary trusts will be ones that are made to an associate pair, given the broad meaning of associate and the modification in section 820-423E being limited to unit trusts.
235. Many transactions that could be caught are those where private groups are simply seeking to comply with ordinary practice in line with existing guidance products.
236. In accordance with the ATO’s guidance on trust distributions to corporate beneficiaries (refer to TD 2022/11 and PCG 2022/2), corporate beneficiaries are encouraged to convert their unpaid trust entitlements into loans where the parties intend for the trust to retain the funds representing the entitlement. This may involve the satisfaction a trust entitlement considered to be a distribution accompanied by the entering into a financial arrangement to fund that distribution. Such a transaction generally occurs between associates.
237. It is possible that the DDCR would apply to deny debt deductions in respect of this kind of common arrangement that occurs between members of private groups and supported by the ATO in the context of Division 7A and section 100A.

238. Such an outcome is inappropriate, and careful consideration needs to be given to the potentially unintended application of the rules to ordinary transactions of this kind that occur within private groups.
239. Case studies outlining the potential considerations for private groups and suggested outcomes are outlined below.

Example 1 –

240. *Trust A is a discretionary family trust that holds an Australian rental property. The property was funded predominantly by way of bank debt, with the deposit advanced to Trust A by way of interest-free loan by an individual family member. Trust A is a general class investor. Each year Trust A derives approximately \$1,000,000 of net rental income for tax and accounting purposes and resolves to distribute this to A Co. Trust A pays \$30,000 of this entitlement to A Co to fund its tax liability with the remaining \$700,000 being unpaid and reinvested to fund costs of maintenance, ownership and improvement of the property.*
241. *Trust A considers that the \$700,000 UPE arising in an income year (2024) becomes a loan in the following income year (2025) in accordance with TD 2022/11. Consistent with the first dot point of paragraph 101 in TD 2022/11, the UPE is made subject to section 109N complying loan terms by lodgment day of A Co's income tax return for year 2025 (e.g. in May 2026). Trust A also considers PCG 2022/2 and enters into the agreement in order to comply with 'green zone 3B' which requires the funds to be made available to Trust A on section 109N terms.*
242. *Trust A incurs debt deductions of \$60,000 for the 2026 year that payable to A Co in accordance with the Division 7A loan.*

Analysis

243. Trust A's debt deductions are payable to an associate pair. It needs to be considered whether its debt deductions relate to the acquisition of an asset from an associate pair or fund a distribution or payment to an associate pair.
244. It should be concluded that Trust A's debt deductions relate to its ordinary activities, being its investment in real estate and the funding of costs relating to holding and maintaining the property.
245. It does not hold any assets acquired from an associate. Further, it only makes distributions to A Co. Although this occurs on a yearly, it is artificial to conclude that the section 109N loan entered into in May 2025 funds a distribution to A Co, even if Trust A distributions to A Co in 2026, 2027, etc while the Division 7A loan is on foot.
246. The UPE arose because Trust A chose (and A Co allowed Trust A) to retain income derived by it for reinvestment. Trust A would not need to borrow from A Co in order to satisfy the UPE owing to A Co. It could simply have paid A Co. It is more accurate to say that Trust A's debt deductions have funded its rental property investment with future rental income funding the future satisfaction of the UPE.
247. Where the \$700,000 was not held as surplus cash at bank and was actually spent by Trust A, if some of that cash was then used to pay down some or all of the UPE in a future year, it would still not be appropriate to conclude that the debt deductions funded a distribution. The most proximate use of the funds was to acquire or increase a bank deposit rather than to pay a distribution.

248. If it were concluded otherwise it would be akin to concluding that an ordinary loan funded the repayment of that same loan despite there being a more immediate or proximate use of the borrowed funds (e.g. even if simply to invest the cash).
249. It should be concluded that the DDCR does not apply to deny deductions under the Division 7A loan.

Example 2 –

250. *The facts are the same as in example 1 except that the UPE that arose in 2024 is satisfied and replaced (i.e. lent back) with a section 109N complying loan in accordance with the second dot point of paragraph 101 in TD 2022/11.*

Analysis

251. The same conclusion should be reached in this example. Whether or not a UPE is placed on complying terms or satisfied and replaced with a new loan does not fundamentally change what the funds are being used for.
252. In this example, the satisfaction of the UPE occurs at an earlier stage. It may be argued that because the distribution immediately precedes the making of the loan that the distribution could be seen as being funded by the loan.
253. However, such a conclusion would arise from a misunderstanding of cause and effect. A Co does not have funds in order to make a loan. It requires those funds from Trust A. Therefore, the distribution is required to be made (i.e. the satisfaction of the UPE) in order to enable A Co to make the loan, rather than the other way round. Trust A does not need to borrow funds in order to make the distribution, it already has those funds represented by its net income.
254. Even if Trust A does not have liquid assets (e.g. its net income is represented by yet to be collected receivables), the agreement to replace the UPE with a loan would still not be one that can be characterised as the making of a loan to fund a distribution. Firstly, in legal form, such an agreement does create payments at law under the principles in Spargo's case so there would first be a payment to A Co that funded A Co's making of a loan back to Trust A. Secondly, the substance of the arrangement is that Trust A is being given more time to satisfy its obligations to A Co in cash. The loan therefore does not fund any payment to A Co as any such payment will ultimately be funded from future cash flows.

Example 3 –

255. *Following on from example 1, Trust A does not make a profit in 2026. In order to meet its obligations under its Division 7A loan, which requires a minimum repayment of \$150,000 under section 109E, Trust A and A Co arrange to fund this repayment by way of franked dividend.*

*A Co is owned by a different discretionary trust (Trust B). A Co's assets consist solely of receivables against Trust A. A Co declares a franked dividend of \$150,000 on 30 June 2026. On the same day, Trust B resolves to distribute the franked dividend to Trust A, which in turn resolves to distribute the franked dividend to Individual A.*

*A Co, Trust A and Trust B each agree to set-off their mutual obligations which results in the dividend being paid by A Co, the distribution from Trust A to Trust B being satisfied and the minimum yearly repayment owing from Trust A to A Co being met.*

*Alternatively, these obligations are met by the entities handing around cheques or promissory notes to each other.*

*The net result is that A Co's net assets and retained earnings are reduced by \$150,000 and Trust A's liability to A Co of \$150,000 (comprising both interest and principal) is reduced by \$150,000 and replaced by a UPE of \$150,000 owed to Individual A.*

#### Analysis

256. Trust A's debt deductions in the 2026 year should be considered to have funded its rental activities. The actions that occur on 30 June should not change this outcome for the 2026 year or subsequent income years.
257. The proximate use of the borrowed funds by Trust A was to reinvest those in its commercial operations.
258. If part of the \$150,000 minimum yearly repayment is considered to be a distribution of trust income (i.e. the further discharge of the 2024 UPE), this is not funded by any borrowings. Rather, it is funded by the payment of a dividend by A Co.
259. Even if one were to look at the matter more indirectly, A Co has not borrowed to fund the dividend to Trust B. There has been no debt created in this instance. The source of the dividend always remained the profits of Trust A. The debt that was created was used to reinvest those profits in the activities of Trust A. The subsequent dividend paid by Trust A was funded by those profits which flowed through to A Co in order to repay the debt owing by way of satisfaction of the distribution. The debt was not created to fund the dividend.
260. It is noted however that a new debt does arise due to the UPE owing to Individual A as at 30 June 2026. If interest is charged on this debt, it may be accurate to describe these debt deductions (if available under section 8-1) as funding a distribution to A Co to some extent (i.e. to the extent of the principal component paid to A Co not the interest component).
261. We note that it would not be necessary to charge interest on a UPE owed to an individual in order to comply with Division 7A or satisfy Green Zone 3A in PCG 2022/2 regarding section 100A. If instead of distributing the dividend to an individual paying marginal rates of tax, Trust A distributed this to another company, this might give rise to interest being charged which could be denied deductibility under DDCR as having funded a distribution. Such an outcome would properly discourage such arrangements which seek to 'freshen up' Division 7A loans by making distributions which remained taxed at corporate rates.

#### Example 4 –

262. *The facts are the same as in Example 3. However, instead of the parties setting-off their mutual obligations, Trust B instead satisfies the entitlement it owes to Trust A by legally assigning its receivable from A Co to Trust A (i.e. an in-specie distribution). Trust A then sets this off against the entitlements it owes A Co in order to meet the minimum yearly repayment owed. These events all occur prior to the end of 30 June 2026.*

#### Analysis

263. The outcomes in example 3 should apply equally here.

264. However, the assignment of a receivable results in the acquisition of a CGT asset by Trust A from its associate pair (Trust B).
265. It needs to be determined whether any of Trust A's debt deductions payable to associates relate to the acquisition of the receivable.
266. Trust A's only debt deductions are those that continue to accrue on amounts owed to A Co. As per the previous analysis, such interest most clearly relates to Trust A's rental activities rather than the making of any distributions or acquisitions of assets.
267. The acquisition of the receivable from Trust B can best be described as funded by the new UPE that becomes owing to individual A. Trust A has effectively borrowed from individual A in order to make a repayment of amounts owing to A Co, which may include the part satisfaction of a UPE (i.e. a distribution).
268. As per example 3, the DDCR should only apply if interest is charged on this subsequent UPE owed to Individual A. The interest that becomes payable to A Co still most properly relates to Trust A's commercial activities. It would not be appropriate to conclude that Trust A is borrowing from A Co in order to repay A Co the very same amounts originally borrowed.