The Tax Institute

The Tax Summit

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Session 14.3: Debt deduction creation rules

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1. Overview

The Australian Taxation Office (**ATO**) has an extensive legislative arsenal for addressing excessive debt deductions arising from cross-border related party debt, including:

- the recently enacted thin capitalisation provisions;
- transfer pricing rules, including the reconstruction provisions;
- the hybrid mismatch provisions;
- the foreign hybrid provisions;
- the debt / equity classification provisions; and
- the general anti-avoidance provisions in Part IVA of the *Income Tax Assessment Act 1936* (**ITAA 1936**), including the diverted profits tax.

Adding to this suite of provisions, the debt deduction creation rules (**DDCR**) contained in Subdivision 820-EAA of the *Income Tax Assessment Act 1997* (**ITAA 1997**) have recently been enacted.[1]

Whilst the DDCR have been framed as a modernised version of the debt creation rules in former Division 16G of the ITAA 1936,[2] in reality the scope and potential application of the DDCR go beyond that of the former Division 16G.

The former Division 16G was repealed in 2001, on the understanding that the thin capitalisation regime in Division 820 would be sufficient to deal with structures which inappropriately 'geared up' Australian subsidiaries of foreign multinationals.[3] Notwithstanding this, the introduction of the DDCR has been justified as a way of supplementing the application of the thin capitalisation rules. This is because the thin capitalisation rules do not necessarily address the risk of excessive debt deductions for debt created in connection with debt push down transactions, including debt created in respect of an acquisition from an associate entity or debt created in funding certain payments to an associate entity. As such, the Government considers that such debt deductions may only ever be indirectly, and at most, partially limited by the thin capitalisation rules.[4]

Despite the commentary in the Explanatory Memorandum to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (**EM**) (which included the DDCR provisions) stating that the DDCR focus on debt-creation schemes involving artificial interest-bearing debt that lacks genuine commercial justification, there is no *purpose* test in Subdivision 820-EAA (other than in the context of the specific anti-avoidance rules relating to schemes entered into by a taxpayers to avoid the application of the DDCR). Consequently, the scope of the DDCR is broad and they can apply to transactions that have a genuine commercial rationale that were not intended to be covered by the stated policy.

The death of cross-border related party debt?

The DDCR, along with the recent changes to the thin capitalisation regime, seem to be directed at discouraging multinational enterprises (**MNEs**) from having cross-border related party debt.

This creates a real problem for Australian subsidiaries of MNEs, including those that are part of a group with an offshore treasury function that borrows centrally and on-lends to global operating subsidiaries.

For a geographically isolated country that has traditionally relied on overseas capital to drive economic growth, there is a real risk that the legislative arsenal listed above (in particular, the DDCR) may disincentivise MNEs

[1] *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024*, which included the DDCR and effectively inserted Subdivision 820-EAA into the ITAA 1997, received Royal Assent on 8 April 2024 (the **Act**).
[2] EM, [2.147]. For a comparison of key aspects of former Division 16G and the new DDCR, refer to the table on page 5 and subsequent commentary in *Debt Deduction Creation Rules* dated 13 June 2024 written by Cameron Blackwood and Simon Mifsud (**Blackwood, 2024**).
[3] *New Business Tax System (Thin Capitalisation) Act 2001 No. 162* (Cth), pt 2 s 4.
[4] EM, [2.145].

from deploying further capital (both in the form of debt and equity) in Australia. This is especially so given the mobility of capital in modern times and the strong competition across countries to attract capital to enhance economic growth.

The purpose of this paper is to summarise the operation of the DDCR, to identify technical issues with the rules and, finally, to review a number of case studies on the operation of the DDCR.

The authors would also like to acknowledge the excellent paper prepared by Cameron Blackwood and Simon Mifsud titled *Debt deduction creation rules – searching for clarity*, which was presented at the National Infrastructure Conference in June 2024 (**Blackwood and Mifsud**). The paper provides a comprehensive overview of the DDCR and some interesting technical comparisons to the former Division 16G as background context.

The authors wish to acknowledge the work and assistance of Pooja Tandon and Charlie Richardson in preparing this paper and the presentation.

2. Scope of the debt deduction creation rules

2.1 Entities to which the DDCR apply

ATO PAG topic – other issue number 10

The DDCR can apply to *general class investors* and *financial entities* that are not authorised deposit-taking institutions (**ADIs**).[5]

A *general class investor* broadly includes the following types of entities (that are not financial entities):

- Australian entities that carry on business in a foreign country at or through a permanent establishment (**PE**) or a controlled entity;
- foreign controlled Australian entities; and
- foreign entities that carry on business at or through a PE in Australia.

This is a consolidation of the general classes of entities to which the former thin capitalisation rules applied, including the 'outward investor (general)', the 'inward investment vehicle (general)' and the 'inward investor (general)'.

Outward and inward investing financial entities reflect the previous 'financial' classes, albeit the definition of a financial entity has been narrowed.[6]

An entity is only subject to the DDCR if the entity's total debt deductions and the total debt deductions of all its *associate entities* is greater than A$2 million for a particular income year.[7] For these purposes, the term *associate entity* is defined in section 820-905 without modification (i.e. generally a 50% *associate interest* threshold).

The general exemption applying to the thin capitalisation rules for outward investing Australian entities with over 90% Australian assets (by market value and as a percentage of total assets) does not apply to the DDCR,[8] meaning that the DDCR could operate to deny debt deductions even if the thin capitalisation rules do not otherwise apply to the entity.

Other entities excluded from the operation of the DDCR include securitisation vehicles,[9] certain insolvency special purpose vehicles,[10] qualifying 'Australian plantation forestry entities'[11] and those entities that have made a choice (or are deemed to have made a choice) to apply the third party debt test (**TPDT**) (discussed further at paragraph 5.3.2 of this paper).[12] In this regard, there is an ordering rule in section 820-31, which provides that an entity must *first* determine whether its debt deductions are allowable under the DDCR, unless the entity has made a choice to use the TPDT for the income year (please refer to paragraph 5.3.2 below). In other words,

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[5] Paragraph 820-423A(1)(a) of the ITAA 1997.
[6] While previously, at paragraph (a) of the definition of *financial entity* in subsection 995-1(1) of the ITAA 1997, a 'financial entity' included a registered corporation under the *Financial Sector (Collection of Data) Act 2001*, this has been narrowed to include a requirement that the registered corporation also carries on a business of providing finance (but not predominantly for the purposes of providing finance directly or indirectly to, or on behalf of, the entity's associates) and derives all or substantially all of its profits from that business.
[7] Section 820-35 of the ITAA 1997.
[8] Section 820-37 of the ITAA 1997.
[9] Paragraph 820-423A(1)(aa) of the ITAA 1997.
[10] Section 820-39 of the ITAA 1997.
[11] Section 146 of the Act.
[12] Paragraphs 820-423A(2)(g) and 820-423A(5)(f) of the ITAA 1997.

the DDCR applies first where the entity relies on the fixed ratio test (**FRT**) or group ratio test (**GRT**) but does not apply where TPDT applies.

2.2 *Associate pair* as modified by section 820-423E

The DDCR will only apply to the extent that the relevant arrangement (whether an acquisition of certain assets or the funding of certain payments) involves an *associate pair*.[13]

An entity is an associate pair of another entity if either of the following conditions is satisfied:[14]

- the entity is an *associate* of the other entity; or
- the other entity is an associate of the entity.

This is a recognition that the definition of *associate* in section 318 of the ITAA 1936 is a 'one-way' street, and that it is possible for a test entity to be an associate of another entity whilst that other entity may *not* be an associate of the test entity.

Accordingly, an *associate pair* is a more expansive class than an *associate*, as an entity may be deemed to be an associate pair of an entity of which it is not, ordinarily, an associate. That said, the widening of the meaning of an *associate entity* for the purposes of the thin capitalisation rules, including the TPDT, by reducing the 50% associate interest test to a 20% *TC control interest* test, does not apply to the meaning of an *associate pair*.

Modification of trust associate test under s 318

Section 820-423E applies to treat certain unit trusts as if they are companies for the purposes of determining whether those unit trusts are an associate pair of another entity. The practical effect of treating a unit trust as if it were a company is that a unitholder will not automatically be considered to be an associate pair of the unit trust, unless the unitholder satisfies the *sufficient influence* test. Example 4 at paragraph 8.4 of this paper demonstrates how entities may need to trace through the definition of associate pair in practice, but in essence this test means that a greater degree of connection is required between a trust and its unitholder for the parties to be considered associate pairs of each other.

2.3 Application to certain arrangements

The DDCR apply to disallow debt deductions on related party borrowing to the extent incurred in respect of the following 2 types of arrangement. The EM observes that these arrangements involve schemes where artificial interest-bearing debt is created within MNEs to shift profits out of Australia via tax-deductible interest payments.

Arrangement Type 1: s*ubsection 820-423A(2)* – the acquisition of a CGT asset, or legal or equitable obligation, from an associate pair. This could include, for example, the acquisition of shares in a foreign subsidiary from a foreign associate, or business assets from foreign and domestic associates in an internal reorganisation after a global merger).[15] For the rules to apply, this acquisition must be made with debt funding from an associate pair.

Arrangement Type 2: s*ubsection 820-423A(5)* – financial arrangements to fund, or facilitate the funding of, certain payments or distributions made to an associate pair of the entity, sourced from debt funding provided by an associate pair. Types of payments or distributions targeted include dividends, distributions by a trustee or

[13] Paragraph 820-423A(2)(b) and subparagraph 820-423A(5)(b)(iii) of the ITAA 1997.
[14] Refer to the definition of *associate pair* in subsection 995-1(1) of the ITAA 1997.
[15] Paragraph 2.150 of the EM.

partnership, returns of capital, royalties or other similar payments for the use or right to use an asset and disbursements by a trustee or partnership.

Both types of arrangement apply where the relevant entity's debt deductions are paid or payable, directly or indirectly, to an associate pair of the payor entity. This means that the DDCR should not apply to debt deductions in respect of debt provided by a *third party* (determined using the associate pair test).

Importantly, neither of these arrangement types contain a purpose test – they are self-executing and deny deductions where the conditions are satisfied. There is likewise no ability for the Commissioner of Taxation (**Commissioner**) to exercise any discretion in applying the rules. Our view is that even a lower purpose threshold (such as a 'not incidental' threshold compared to a 'dominant purpose' test) would better target the DDCR provisions and reduce the likelihood of their application in unintended circumstances.

Each of these types of arrangement is considered in further detail below.

3. Arrangement type 1 – acquire a CGT asset, or legal or equitable obligation

3.1 Introduction

ATO PAG topic – other issue number 6

The conditions for the first arrangement type are as follows:

1. an entity (the **acquirer**) acquires a CGT asset, or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a **disposer**);
2. one or more of the disposers is an associate pair of the acquirer (**associate disposer**);
3. the entity which claims the debt deductions (**relevant entity**) must be the acquirer, an associate pair of the acquirer or an associate pair of an associate disposer;
4. the relevant entity's debt deduction is wholly or partly in relation to the acquisition, or holding, of the CGT asset, or legal or equitable obligation;
5. the relevant entity's debt deduction is referable to an amount paid or payable, either directly or indirectly, to an associate pair of the relevant entity, the acquirer or the associate disposer;
6. the acquisition is not subject to an exception (see paragraph 3.3.2 below); and
7. the relevant entity has not made a choice to use the TPDT for the relevant year.

Where the above conditions are satisfied, debt deductions claimed by the payer are disallowed under subsection 820-423B(1) 'to the extent' (i.e. on a proportionate basis) that the relevant entity incurred it wholly or partly in relation to the acquisition, or holding of, the CGT asset, or legal or equitable obligation (paragraph 820-423A(2)(d)).

3.2 CGT asset or a legal or equitable obligation

The EM and Supplementary Explanatory Memorandum to *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (**Supplementary EM**) contain minimal guidance on which assets and obligations are covered by the DDCR, other than recognising that Australian currency is not a CGT asset when used in legal tender and is therefore not expected to be caught by the DDCR.[16] Notwithstanding that recognition, AUD in a bank account and negotiable instruments are arguably CGT assets and therefore may be covered by the DDCR.

A *CGT asset* is any kind of property, including a legal or equitable right that is not property.[17] While this may make the reference to a legal or equitable obligation somewhat redundant, it does clarify the Government's intent that all assets and obligations will be covered by the rules, even if enforceable only in equity. There are limited commercial assets which fall outside this definition (a key one being *know how*), but most commercially

[16] Paragraph 1.40 of the Supplementary EM.
[17] Section 108-5 of the ITAA 1997.

valuable assets are caught even if they are not recognised for accounting purposes – this includes, for example, internally generated goodwill.

The reference to the acquisition of an obligation (in law or at equity) is somewhat nebulous in the context of a provision primarily targeted towards asset acquisitions. There is no ATO-issued guidance on this point. Given the breadth of the concept of an obligation, we can see it applying to things like the assignment of leases. Blackwood and Mifsud note that the term can be construed very broadly to include the acquisition of related party services (e.g. captive insurance, royalty payments, swap payments and service agreements).[18] We do not disagree with this observation, and consequently the scope of these rules could be broader than expected.

3.3 Acquisition of an asset or obligation

3.3.1 Direct and indirect acquisitions

As outlined above, the DDCR may apply where, *inter alia*:

> *an entity (the **acquirer**) acquires a CGT asset, or a legal or equitable obligation, either <u>directly</u> or <u>indirectly through one or more interposed entities</u>, from one or more other entities (each of which is a **disposer**)…* <u>[Emphasis added]</u>

In either circumstance – a direct or indirect acquisition – the taxpayer will be taken to *acquire* a CGT asset in the circumstances and at the time worked out under Division 109 of the ITAA 1997 (contained within the Australian CGT provisions).[19] This can therefore include the *issue* of an asset.

Direct acquisitions

Whether there is a direct acquisition should be fairly straightforward to confirm. Example 2 at paragraph 8.2 of this paper sets out how the DDCR may apply in a direct acquisition context, where an Australian resident entity acquires trading stock (a non-exempt CGT asset) funded by related party debt.

Indirect acquisitions

The concept of *acquisition* is broadened by the inclusion of the words *indirectly through one of more interposed entities*. A transaction may therefore come within the scope of the DDCR even if the indirect acquisition happens because of a direct acquisition by the first entity of a CGT asset covered by one of the three exceptions in section 820-423AA. This is confirmed in paragraph 1.39 of the Supplementary EM, which states:

> *Provisions make clear that subsection 820-423A(2) may apply in relation to the indirect acquisition by an entity of a CGT asset through an interposed entity, even if the indirect acquisition happens because of the direct acquisition by the first entity of a CGT asset covered by one of the three exceptions.*

Take, for example, a transaction involving the following:

1. an entity obtains related party debt funding to acquire new membership interests in a subsidiary (which would have been an exempt direct acquisition); and

2. that subsidiary then uses those funds to acquire a separate CGT asset from a related party.

[18] Blackwood, 2024, page 12.
[19] See the definition of 'acquire' in subsection 995-1(1) of the ITAA 1997.

In these circumstances, the DDCR would still apply to deny debt deductions in respect of that related party debt funding.

See Example 8.3 of this paper for an illustration of a transaction that would have ordinarily been an exception under section 820-423AA but which is nevertheless caught on the basis that the arrangement is structured as an indirect acquisition. The legislation is also clear that the DDCR can apply multiple times along a chain of entities.[20]

The fact that the DDCR seek to capture acquisitions made indirectly by an entity (i.e. through one or more interposed entities) has the potential to significantly expand the application of the DDCR and may necessitate tracing exercises to test the application of the DDCR, which can be cumbersome and difficult. It certainly means the tracing cannot stop at the acquisition of new shares or debt (which are exceptions), but must flow through to the underlying use of those funds by the recipient.

Taxpayers must exercise evidentiary discipline to ensure that adequate records are maintained in relation to acquisitions, including how such acquisitions are funded, to ensure that they can establish whether or not the DDCR would apply to a particular transaction. It would also be helpful to ensure that any documents specifically identify the use of funds and, where possible, avoid vague descriptions such as 'use for general corporate purposes'. While we acknowledge that this is not always possible, such drafting does not provide strong evidentiary support for the use of funds in a permitted manner.

ATO guidance on the scope of these rules is currently on the ATO's priority list.[21]

3.3.2 Exceptions for certain CGT assets – section 820-423AA

Under section 820-423AA, there are a number of exempt acquisitions:

1. **New membership interest:** The acquisition of new membership interests in Australian entities and foreign companies is disregarded (i.e. use of related party debt to acquire shares), although as noted above and below, the ultimate use of the proceeds may be caught as an indirect acquisition.

2. **New tangible depreciating assets:** the acquisition of certain new tangible depreciating assets is disregarded. Paragraph 1.38 of the Supplementary EM indicates that 'this exception is broadly intended to allow an entity to bulk-acquire tangible depreciating assets on behalf of its associate pairs'. Note that the definition of a depreciating asset in subsection 995-1(1) of the ITAA 1997 refers to a Division 40 depreciating asset and therefore will not apply to tangible depreciating assets caught by other divisions, with a clear omission being trading stock (even though trading stock was an exception in former Division 16G of the ITAA 1936). Intangible assets are specifically not excepted.

3. **New debt interests:** The acquisition of new debt interests is disregarded. Paragraph 1.38 of the Supplementary EM indicates that this is a 'technical exception which ensures that mere related party lending is not caught by the rules'. The necessity for this carveout further serves to highlight the otherwise extreme breadth of the DDCR, insofar as issuing debt to a related party would technically be the acquisition of a legal interest referable to amounts paid by an associate.

While these exceptions are welcome, particularly when coupled with the narrowing of the definition of *associate pair* with respect to unit trusts and the requirement for the debt to be from an associate pair (i.e. related party),

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[20] Section 820-423A(3A) of the ITAA 1997.

[21] Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation | Australian Taxation Office. We understand that the ATO is expected to provide guidance from a practical and administrative perspective, ie how entities are expected to manage compliance with these rules in respect of indirect acquisitions and at what point the nexus between debt incurred and the asset acquired by some intermediary is considered to be broken).

they are still fairly narrow and there are still examples of ordinary commercial transactions, including trading stock financing, which would not fall within these exceptions.

In our view and as a matter of practicality, the ATO should as soon as possible issue guidance on which arrangements it views as being higher risk.

4. Arrangement type 2 – fund, or facilitate the funding of, payments to an associate pair

4.1 Introduction

ATO PAG topic – other issue number 6

The second arrangement type to which the DDCR applies is where an entity enters into a *financial arrangement* to *fund, or facilitate the funding* of, a *prescribed payment* to that, or another, associate pair.

The conditions for the second arrangement type are as follows:

1. an entity (the **payer**) enters into or has a *financial arrangement* with another entity;
2. the payer uses the financial arrangement to fund or facilitate the funding of covered payments or distributions made to an associate pair;
3. the entity which claims the debt deductions must be the payer, an associate pair of the payer or an associate pair of an associate recipient (**relevant entity**);
4. the relevant entity's debt deductions are wholly or partly in relation to the financial arrangement;
5. the payer's debt deduction is referable to an amount paid, either directly or indirectly, to an associate pair; and
6. the TPDT has not been chosen, or deemed to have been chosen (discussed more at paragraph 5.3 below).

Where the above conditions are satisfied, debt deductions are disallowed under subsection 820-423B(2) 'to the same extent' (i.e. on a proportionate basis) that the payer uses the financial arrangement in a manner that satisfies paragraph 820-423A(5)(b), being to fund or facilitate the funding of a prescribed payment.

Example 1 at paragraph 8.1 below demonstrates how this second limb of the DDCR may apply where an Australian parent entity provides debt to a foreign subsidiary, which then distributes a dividend or makes some other capital reduction distribution to an Australian entity. Any interest that the foreign subsidiary attempts to deduct that is referable to the financial arrangement would be disallowed.

4.2 Elements of Type 2 arrangements

Other than the concept of an *associate pair,* the key elements of the second arrangement type are the existence of a *financial arrangement*, a *prescribed payment* and the link between the two being the *funding or facilitation* of such a prescribed payment.

4.2.1 Financial arrangements

Paragraph 820-423A(5)(a) provides that there must be a *financial arrangement* entered into by the payer with another entity. The existing definition of financial arrangement in the TOFA rules in sections 230-45 to 230-55 of the ITAA 1997 applies for these purposes and the guidance relevant to Division 230 would likewise apply here.

Under section 230-45, a financial arrangement includes an arrangement where the taxpayer has a cash settleable legal or equitable right to receive or provide a *financial benefit*, subject to certain exceptions. For these purposes, the term financial benefit is defined broadly in section 974-160 to include 'anything of economic value'. Importantly, a 'benefit' includes the creation or assumption of an obligation on the entity conferring the benefit.

The definition of financial arrangements also includes an equity interest under section 230-50, and this includes interests in trusts and partnerships by virtue of section 820-940.

Equally where the arrangement entered into by the payor is not a *financial arrangement* – for example, there is the provision of a material *non-cash settlable* right by the counterparty, even if this is in addition to a cash settleable right – then the arrangement should not be a second arrangement type.

4.2.2 Prescribed payments – subsection 820-423A(5A)

Subsection 820-423A(5A) lists the following types of payments and distributions as being within the scope of the DDCR:

1. a dividend, distribution or non-share distribution;
2. a distribution by a trustee or partnership;
3. a return of capital, including a return of capital made by a distribution or payment made by a trustee or partnership;
4. a payment or distribution in respect of the cancellation or redemption of a membership interest in an entity;
5. a royalty, or similar payment or distribution for the use of, or right to use an asset;
6. a payment or distribution that is wholly or partly referable to the payment of principal under a debt interest if the debt interest is issued by the payer and the debt interest is a financial arrangement that satisfies the paragraph 820-423A(5)(a), (b) and (c) conditions (i.e. refinancing a loan);
7. a payment or distribution of a kind similar to the ones mentioned above; or
8. a payment or distribution prescribed by the regulations.

Breadth of prescribed payments

Items 1 to 6 above are generally fairly straightforward to identify, though there may be debate as to whether payments should be characterised as being in respect of the cancellation or redemption of interests, or the breadth of the extension to item 5. For example, would this catch the payment of a franchise fee if the fee has components (not necessarily dissected) which relate to the use of IP, or to the right to acquire a system or other ingredients? Similarly, would this apply to a payment for know-how?

Item 7 is likewise potentially very broad. However, the statutory principle of *ejudsem generis* should apply to limit the kinds of prescribed payments, though it is difficult to conceive of payments which are of a similar kind as items 1 to 6 inclusive that are not caught but should be caught under item 7.

Refinancing may be caught

Item 6 may potentially capture refinancing of an existing loan where the proceeds of the original loan are used to make a prescribed payment (**Tainted Loan**). This is potentially the case even where the Tainted Loan is drawn down prior to the start of the DDCR. By way of example, if an entity refinances an existing loan with related party debt prior to the start of the DDCR, interest deductions in respect of the previously refinanced debt may be denied from the start of the DDCR.

4.3 Fund or 'facilitate the funding of'

The conditions in subsection 820-423A(5) contemplate financial arrangements that either directly fund, or *facilitate the funding of* one or more of the captured payments. Paragraph 1.49 of the Supplementary EM refers to an indirect connection between the financial arrangement and the eventual payment or distribution as follows [**emphasis added**]:

> *…For the payer to facilitate the funding of a payment or distribution, there must be an* ***indirect connection*** *between the use of the financial arrangement and the funding of the payment or distribution. This may involve a* ***consideration of whether the use of the financial arrangement can reasonably be said to have allowed for, directly or indirectly, the funding of the payment or distribution****.*

To fund a payment is a relatively straightforward test – it imports a traceable direct connection between the end payment and the proceeds of the financial arrangement.

The phrase 'facilitate the funding of' is broader and imports the indirect connection referred to in the Supplementary EM. However, an issue arises in relation to the breadth of the concept of *facilitating* the funding of another payment.

On one view, it may simply be the case that the phrase 'facilitating' refers to funding through interposed entities (i.e. funding via a treasury company in a corporate group). Explicit confirmation of this can be found in paragraph 820-423A(6)(a)(i) and subsection 820-423A(7). These provisions appear to confirm that it will be sufficient for there to be a second arrangement type where prescribed payments are made 'directly, or indirectly though one or more interposed entities', in which case 'it is sufficient if payments exist between each interposed entity' (though each payment need not necessarily fund the next payment). Such wording may necessitate tracing and apportionment exercises to test the application of the DDCR, which again can be cumbersome and difficult (see our further comments on this point in paragraph 5.2).

On another view, the definition of *facilitate* is simply 'to make something easier'. This is a much lower bar than being able to trace the source of a payment through a number of entities. For example, making cash available through an equity issue or a new borrowing may be said to facilitate a payment where the proceeds make it *easier or simpler* to fund the prescribed payment. This may be the case even if the proceeds are not required to make the prescribed payment – by way of example, an equity injection may be made to permit a subsequent payment where the absence of the equity injection would mean that the subsequent payment is not permitted under debt covenants.

Although the term 'facilitate' may be interpreted broadly, it does not seem to us to be the preferred reading. In this regard, it is instructive to note that this provision formerly referred to a third limb which caught financial arrangements which increased the ability of an entity to make one or more payments or distributions to one or more other entities (a recipient), regardless of whether the recipient is an associate pair of the payer. Both the reference to any payment to a third party and the increased ability to make the payment were narrowed in the final form of the rules.

There is no doubt that the former drafting was much broader. The phrase *increases the ability* of an entity to pay can be interpreted very liberally to include, for example, obtaining the proceeds of a loan even though the entity is subject to an obligation to repay the principal at a later date. The legislative intention has clearly been to narrow the scope of the requirement, but not so as to create obvious holes in the regime.

Our view is that a taxpayer would need to consider tracing the source of funds carefully to evidence the requisite connection where the prescribed payment is directly out of the proceeds of the financial arrangement, or it would not have been possible without the proceeds of the financial arrangement. It is not clear what level of 'facilitation' is required. For example, if it was financially imprudent to make the prescribed payment without the proceeds of the financial arrangement, although it was possible, does this satisfy the test? Indeed, one party's approach to risk taking may vary markedly to another party's approach, however, the test remains the same for both – that is to facilitate the payment of the prescribed payment. This is an uncertain area about which ATO guidance would be welcomed. That said, as Blackwood and Mifsud note in their paper (especially Appendix A of their paper), there are examples in case law that the ATO raised to the Senate Economics Legislation Committee (**SELC**) which are illustrative of the ATO's views regarding what types of transactions ought to be caught under the DDCR.

Regardless, taxpayers must exercise evidentiary discipline to ensure that adequate records are maintained in relation to funding received from related entities and the purposes for which such funding is used. Records should also be maintained in respect of any payment to associates so that the sources of funds are clearly articulated.

5. Implications of the DDCR

5.1 Disallowance of debt deductions

ATO PAG topic – other issue number 7

Under type 1 arrangements, debt deductions are to be disallowed to the extent that the relevant entity incurred the debt deductions in relation to the acquisition or holding of the relevant assets.

Under type 2 arrangements, debt deductions are to be disallowed to the extent that the payer uses the financial arrangement to fund or facilitate the funding of one or more payments or distributions to which the payment condition applies.[22]

This will require detailed tracing of the source and uses of funds.

5.2 Tracing requirements

Background to the tracing issue

As foreshadowed above, taxpayers may be required to undertake complex and cumbersome tracing exercises to determine the tax implications of the DDCR. The use of apportionment language such as 'to the extent' and 'facilitate the funding of' in subsection 820-423A(5)(b) suggests that a tracing exercise will need to be undertaken to determine how the payer has used monies received by its associates.

Simple tracing

In the simple case, tracing may be reasonably straightforward where there is a clear point A and point B for monies received by a payer – for instance, where a payer provides debt to a related party that places the debt into a separate account and uses that money partly or wholly for a dividend distribution or another captured payment.

Problem with cash pooling

The exercise quickly becomes complicated where there is pooling of cash, given the fungibility of cash. Consider a scenario where a party borrows from an associate and places monies received into a high turnover cash pool. Parties to the pool may use pooled monies for many different purposes, one of which might be a payment prescribed under subsection 820-423A(5A). It becomes difficult to identify which monies in the cash pool account were used to fund the prescribed payment. This example should not be dismissed as a fringe case, given the common usage of a treasury company in most corporate groups.

Example 7 of this paper illustrates that the DDCR may undermine common group treasury functions and cash pooling arrangements. That said, the following arrangements may not be impacted:

- notional cash pooling arrangements where the funding is sourced from an external third party and the pool balances are all beneficially with the third party financier, rather than a group financier; and
- where an entity that has a positive balance with a group treasury entity draws down on that to fund a prescribed payment, as opposed to an entity in the group that has a liability to the pool further drawing down to make the same payment.

[22] Section 820-423B of the ITAA 1997.

Problem with historical records and ATO guidance

The DDCR will deny debt deductions from 1 July 2024, with no 'grandfathering' of existing arrangements.

Taxpayers should test the DDCR to historical transactions for debt arrangements to ascertain whether any funding received from an associate pair which subsisted on 1 July 2024 was used to acquire a CGT asset or relevant obligation, or to fund prescribed payments to an associate pair.

Practically, despite a taxpayer's best efforts, it may not be possible to conclusively trace the use of funds received from an associate pair where adequate records have not been created or maintained, or it does not have the means or resources to undertake such complex tracing exercises. This may be compounded by the fact that the debt with a related party may have been refinanced multiple times, making it difficult for the taxpayer to trace through a complex web of transactions to the original use of the debt.

Treasury recognising the above difficulties but, ultimately noted that:

> *… a wider concession, as sought by industry, would introduce competitive neutrality issues, reduce the integrity of the new thin capitalisation rules, and increase compliance complexity going forward. Integrity risks would include businesses seeking to roll over grandfathered financing arrangements (that would otherwise result in denied debt deductions) to avoid the integrity rules in perpetuity.*
>
> *We expect that the ATO, consistent with other legislative changes, will issue guidance on transitional arrangements to assist taxpayers.*[23]

In response to concerns raised by industry stakeholders and Treasury's above statement, the ATO has developed a priorities issue list, which included the following statement:

> *We will also consider providing compliance guidance on tracing and apportionment issues relating to historical debt arrangements for the purposes of applying the DDCR. The ATO's commitment to providing guidance on this aspect of this topic will be dependent on stakeholder engagement and submissions.*

It is no doubt true that such guidance must not, from a policy perspective, create complexity and ongoing competitive neutrality issues. However, we consider it is not entirely appropriate to dismiss the real concerns relating to debt issued prior to the introduction of the DDCR, given taxpayers could not have been aware of the rules applying to them at the time of the drawdowns. Our view is that the ATO guidance may provide a transitional path to ensure that taxpayers are treated equitably. We await guidance from the ATO on how these tracing exercises might be conducted and, importantly, when the ATO will require tracing exercises for historical borrowings.

5.3 Interaction with thin capitalisation rules

ATO PAG topic – other issue number 6

5.3.1 *Fixed ratio test* and *group ratio test*

Section 820-31 addresses the interaction between Subdivision 820-EAA and the thin capitalisation provisions in Division 820.

[23] Chapter 2 - Views on the amendments – Parliament of Australia (aph.gov.au). paragraph 2.81.

Under section 820-31, an entity must *first* determine whether its debt deductions are allowable under the DDCR, unless the entity has made a choice to use the TPDT for the income year (please refer to paragraph 5.3.2 below).

To the extent that the default FRT applies to an entity (because no choice to use another method has been made) or a choice to use the GRT has been made for thin capitalisation purposes, it is possible for the thin capitalisation and DDCR rules to both apply, subject to the order of priority provision in section 820-31.

Relevantly, should any debt deductions be disallowed under the DDCR, the disallowed debt deductions are disregarded for the purposes of applying all other provisions in Division 820. The other provisions in Division 820 may then apply to disallow, wholly or partly, an entity's remaining debt deductions.

5.3.2 *TPDT*

Under subsections 820-46(4), 820-85(2C) and 820-185(2C), a general class investor, an outward investing financial entity (non-ADI) and an inward investing financial entity (non-ADI) can each make a choice to apply the TPDT.

Further, under subsection 820-46(5) and section 820-48, a general class investor (but not an outward investing financial entity (non-ADI) and inward investing financial entity (non-ADI)) can be deemed in certain circumstances to have made a choice to apply the TPDT.

As noted above, if an entity has made (or, in the case of general class investors, is deemed to have made) a choice to apply the TPDT, the DDCR do not apply.[24]

The policy rationale for this exclusion is set out at paragraph 1.45 of the Supplementary EM as follows:

> *Broadly, an entity that chooses the third party debt test for the income year will effectively be exempt from the debt deduction creation rules for that income year. This exemption recognises that such entities are subject to the third party debt conditions in Subdivision-EAB. These conditions are intended to ensure that an entity's debt deductions are only allowed where they are attributable to genuine third party debt that is borrowed against Australian assets and is used to fund Australian operations.*

[24] Paragraphs 820-423A(2)(g) and 820-423A(5)(f) of the ITAA 1997.

6. Implications for corporate / public groups

6.1 Conduit financing

Corporate and public groups will be interested in the interaction between conduit financing arrangements and/or cash pooling arrangements and the DDCR.

For conduit financing arrangements, we broadly refer to scenarios in which one corporate assists another smaller corporate in the same group to access finance, by borrowing funds and then on-lending those funds to another smaller group entity.

Where entities apply the TPDT, there is a concession for conduit financing arrangements in sections 820-427B and 820-427C. Further, as discussed in section 5, where the TPDT applies, the anti-overlap provisions in paragraphs 820-423A(2)(g) and 820-423A(5)(f) exclude the operation of the DDCR.

However, this leaves conduit financing arrangements vulnerable to the operation of the DDCR where entities have not made (or have not been deemed to have made) a choice to apply the TPDT.

Conduit financing will not inherently trigger the DDCR, insofar as a taxpayer does not breach either limb by simply providing a debt interest to a related party (as much is ensured by subsection 820-423AA(3)), but the danger lies in the use of the funds by the related party. Given that no such conduit financing exemption applies for the DDCR, the following issues will frequently present themselves if the TPDT is not elected:

1. Where the conduit financer obtains a loan from a third party and on-lends to an associate pair, any CGT asset, or legal or equitable obligation, acquired by the ultimate borrower would be caught as an arrangement type 1. Using the example in paragraph 3.3.3 above, where a conduit financer on-lends a loan to an associate pair which then acquires membership interests in another related party, any deductions would be disallowed, irrespective of the fact that this arrangement would have been exempt under section 820-423AA were it a direct acquisition.

2. Where the conduit financer obtains a loan from a third party and on-lends to an associate pair, if that associate pair then makes a prescribed payment with monies received (such as a dividend distribution or some other return of capital), then there is a financial arrangement which would be caught as an arrangement type 2.

These are unfortunate applications of the DDCR given that the arrangements would have been treated concessionally were they to fall within sections 820-427B and 820-427C. See Example 5 at paragraph 8.5 for how the DDCR rules may apply to arrangements that may otherwise have been exempt for entities covered by the TPDT.

The above examples should be viewed as somewhat simplistic applications of financing within corporate groups. In commercial reality, money is fungible and easily lost track of when treasury companies are injected into the group funding structure and cash pooling is frequent. The tracing issues with cash pooling and various alternatives have been illustrated at Example 7 below.

6.2 Restructures and the anti-avoidance rule

ATO PAG topic – high priority issue number 1

The DDCR contain embedded and specific anti-avoidance provisions, which apply in addition to Part IVA of the ITAA 1936, empowering the Commissioner to disallow debt deductions claimed by an entity where he is satisfied that the entity has entered into a scheme with the *principal purpose* of avoiding application of the DDCR (section 820-423D of the ITAA 1997).

Note that the term principal purpose is also used in the *diverted profits tax* provisions of Part IVA (refer to section 177J) and is considered to be a lower threshold than the *dominant purpose* test required in the general anti-avoidance provisions of Part IVA (refer to section 177D).

These *schemes* will ordinarily apply to arrangements involving an attempt to 'wash' a debt interest of its original character by refinancing with an external financial institution. Such washing seems to be permitted where there is some commercial reason for doing so (i.e. a taxpayer has existing debt with a financial institution and it makes commercial sense to have all debt held by a single institution), but may otherwise be avoidance and subject to section 820-423D. Refer to Example 6 at paragraph 8.6 below for an example of refinancing a related party debt in scenarios where there is or is not a commercial reason for doing so.

It is stated in paragraph 1.44 of the Supplementary EM that section 820-423D is not intended to capture restructures 'without any associated artificiality or contrivance'. However, as an evidentiary matter, there will be an ongoing risk of debt refinancing arrangements being labelled as artificial or contrived schemes for section 820-423D purposes where meticulous records are not kept and the taxpayer cannot therefore demonstrate a commercial purpose.

We question, as a matter of fairness, whether the specific anti avoidance rule in section 820-423D should be applied to restructures which aim to refinance debt that is non-deductible under DDCR with deductible debt, particularly where the original arrangements were entered into prior to the announcement of the DDCR. It seems to us that requiring a taxpayer to wait for a commercial reason to refinance the debt could be unfair to taxpayers who entered into arrangements based on the law at the time. This is particularly the case where, tax considerations aside, the proposed refinance would increase the cost of debt. Paradoxically, it may be open to the Commissioner to argue that while this was the taxpayer attempting to comply with the law, accepting a higher rate of interest is, in fact, indicative that the transaction is explicable only by protecting the benefit of the tax deduction and therefore caught by the integrity rules.

This issue is a matter of high priority for the ATO and the Commissioner has committed to providing guidance on the 'application of Part IVA and/or the Debt Deduction Creation Rules (DDCR) specific anti-avoidance provision (820-423D) to certain restructures in response to the new law'.[25] We would hope that the Commissioner would acknowledge the difficulties presented by pre-DDCR debt and provide the appropriate safe harbours for restructuring.

[25] Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation published 10 May 2024.

7. Implications for private groups

7.1 Division 7A – unintended interactions?

ATO PAG topic – other issue number 7

It has already been shown that the broad stroke drafting of the DDCR may have unintended consequences, and this includes unanticipated interactions with Division 7A of the ITAA 1936. It must be noted that the application of the DDCR to private groups may be limited as they will need to qualify as *general investors* and not be exempted from Division 820 under the de minimis $2 million threshold. Consequently, smaller private groups that are Australian controlled and do not have foreign controlled entities would not be subject to DDCR. However, larger private groups may well meet the thresholds and will have to deal with the potential of both DDCR and Division 7A applying. This can present a number of issues, including:

- managing the payment of cash out of private groups – arrangement type 2 may impact the ability to fund distributions by entities to the owners, even if Division 7A is complied with;
- implications for group restructures where assets are transferred within group structures funded by loans or vendor finance; and
- interaction with section 100A and reimbursement agreements.

Managing cash repatriation

Broadly, Division 7A can deem a loan made by a private company to a shareholder or an associate of the shareholder to be an unfranked dividend, subject to the loan meeting the conditions prescribed by section 109N of the ITAA 1936. One condition is that the rate of interest payable on the loan for years of income after the year in which the loan is made equals or exceeds the *benchmark interest rate* for the year.[26]

There are exceptions in Division 7A for loans made between companies (section 109K) or loans made in the ordinary course of business (section 109M). However, other than these exceptions, it may be the case that a loan (or transaction in substance reflecting a loan – paragraph 109D(3)(d)) between a private company and a partnership or trust could potentially attract the operation of both Division 7A and the DDCR at the same time. This would include Division 7A loans structured to satisfy the conditions under section 109N. In these circumstances, there is no accounting for the fact that arguably the same benefit is taxed twice, that is, there is no anti-overlap rule.

For instance, a loan may be Division 7A compliant, but the borrower may then use the proceeds of the loan to acquire a CGT asset from an associate as contemplated by arrangement type 1, or to make a prescribed payment for the purposes of arrangement type 2.

The unintended consequence here would be that a relevant entity may be denied the ability to claim debt deductions under the DDCR, despite paying benchmark interest under the arrangement to comply with the requirements of section 109N of the ITAA36.

Examples 8 and 9 at paragraphs 8.8 and 8.9 are examples where both Division 7A and the DDCR may apply to an arrangement. On 26 August 2024, the ATO confirmed its view that DDCR can still apply to deny deductions on complying Division 7A loans.[27]

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[26] It should be noted that for the purposes of Division 7A, an advance of money or a provision of credit or other form of financial accommodation may also be capable of being characterised as a 'loan' and subject to the relevant deeming provisions.
[27] See https://www.ato.gov.au/businesses-and-organisations/corporate-tax-measures-and-assurance/debt-deduction-creation-rules-and-division-7a

Managing group restructures

Private groups should consider the potential for arrangement type 1s to apply in any group restructure involving vendor financing or the creation of intercompany loans. This may be missed where loans between private companies are structured to rely on the section 109K exemption in Division 7A. This will not, of course, prevent the DDCR from denying the interest deductions on arrangement type 1 loans even though they are not subject to deemed dividend treatment under Division 7A.

7.2 Reimbursement agreements and section 100A

Section 100A of the ITAA 1936 is an integrity provision that applies to trust structures, and is designed to deny taxpayers the benefit of a *reimbursement agreement*. More precisely, and as explained in Taxation Ruling TR 2022/4, the section operates where a beneficiary's present entitlement arises out of, or in connection, with an arrangement:

- involving a benefit being provided to another person;
- intended to have the result of reducing someone's tax liability; and
- entered into outside the course of ordinary family or commercial dealings.

Fortunately, as compared to Division 7A, the opportunity for double taxation or penalty appears far less likely.

This is primarily a result of subsection 100A(6A), which operates to disallow interest deductions where a reimbursement agreement arises. Where a reimbursement agreement arises with respect to an interest-bearing loan, the DDCR and section 100A should operate in a similar way to neutralise the benefit.

However, taxpayers should be aware that arrangements which are designed to comply with section 100A (and are in fact encouraged by the ATO) may still be subject to the DDCR, resulting in a denial of debt deductions.

Example 10 at paragraph 8.10 below (which is based directly on Diagram 3 of Practical Compliance Guideline PCG 2022/2 *Section 100A reimbursement agreements – ATO compliance approach*) is an example of a 'green zone' structure in the PCG relating to section 100A. In this example, a trustee of a trust makes a corporate beneficiary presently entitled to an amount of income, that the corporate beneficiary lends back to the trustee on an interest-bearing basis that complies with section 109N.

While the Commissioner indicates in PCG 2022/2 that no compliance resources would be applied to such a structure, if subject to the thin capitalisation rules, the use of funds by the trustee may give rise to a denial of interest deductions.

A trustee is an associate of a corporate beneficiary[28] and if the loaned funds are used in a non-compliant manner (such as being used to acquire a CGT asset from, or make a specified payment to, an associate of the trustee, including another beneficiary of the trust), the DDCR would apply to deny interest deductions.

This may also be the case where, instead of a commercial loan, the corporate beneficiary instead has an unpaid present entitlement (**UPE**). In Taxation Determination TD 2022/11, the Commissioner observes that the provision of a financial benefit, including where a commercial rate of return is paid, may constitute a loan for the purposes of subsection 109D(3).

TD 2022/11 is of course subject to the decision in *Bendel and Commissioner of Taxation* [2023] AATA 3074 (***Bendel***), in which the Administrative Appeals Tribunal held that a UPE of a corporate beneficiary did not constitute a loan within the meaning of subsection 109D(3).

Assuming that *Bendel* is upheld on appeal, it is not clear whether the decision would prevent the Commissioner from considering that a rate of return paid on a UPE is interest, or an amount economically equivalent to interest, for the purposes of Division 820 and the DDCR. Even if the Commissioner is required to hold that a

[28] Paragraph 318(2)(c) of the ITAA 1936, and an entity that benefits under a trust will be an associate of a trustee under paragraph 318(3)(a) of the ITAA 1936.

UPE is not a loan for Division 7A purposes, there is significant uncertainty as to whether the Commissioner could use the DDCR to attack the same structure where a rate of return is paid.

Detailed guidance from the ATO would be welcomed.

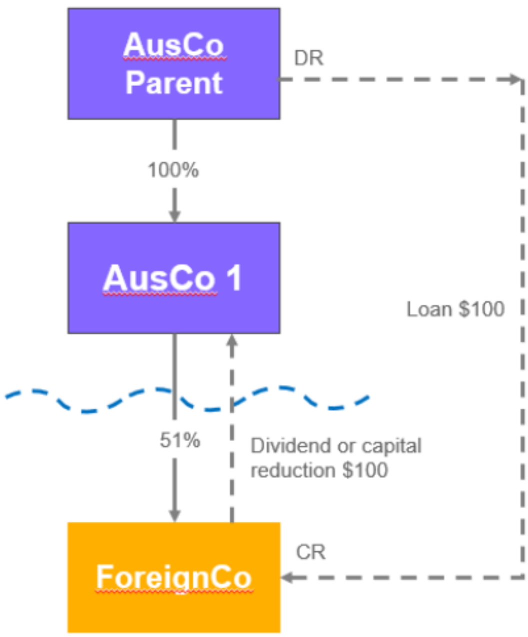
8. Case studies

8.1 Example 1 – Distribution to associate funded by a loan from an associate (Type 2)

DDCR arrangement type 2 may apply to foreign vehicles that are Australian residents

Assume that ForeignCo is an Australian tax resident under the central management and control test in section 6 of the ITAA 1936.

In these circumstances, section 820-423A(1) would apply to deny ForeignCo an Australian debt deduction on the Loan since ForeignCo is a general class investor, it is not a securitisation vehicle and the conditions in subsection 820-423A(5) are satisfied, as follows:



(a) s820-423A(5)(a) **Financial Arrangement:** ForeignCo is a payer that has entered into a loan (financial arrangement) with another entity (AusCo Parent).

(b) s820-423A(5)(b) **Fund or facilitate the funding of payment to associate pair:** ForeignCo has directly used the $100 Loan to fund the payment of a dividend or capital reduction (see sub (5A)) to an 'associate pair', being AusCo 1. AusCo 1 is an associate of ForeignCo since it is has a 'controlling interest' in ForeignCo. The Loan has funded the payment since they are the same amount, occur contemporaneously and ForeignCo did not otherwise have the funds.

(c) ss820-423A(5)(c) and (d) **Debt from associate pair**: The borrower (i.e. ForeignCo) is the *payer* and the interest relates to the debt from the associate pair.

(d) s820-423A(5)(e) **Interest paid to associate pair**: ForeignCo's interest is referable to an amount paid or payable directly to an associate pair of an associated recipient i.e. to AusCo Parent.

(e) s820-423A(5)(f) **Borrower does not apply TPDT**: ForeignCo has not chosen to use TPDT.

Alternative scenarios

- If ForeignCo had sufficient cash reserves without borrowing the Loan, there may be an argument that the DDCR does not apply, particularly if the prescribed payment occurred significantly prior to the Loan proceeds being available, was a substantially different amount, and records were retained demonstrating that the payment was not conditional on the Loan and not funded from the same cash proceeds.
- If ForeignCo was not an Australian resident the DDCR would not be an issue.

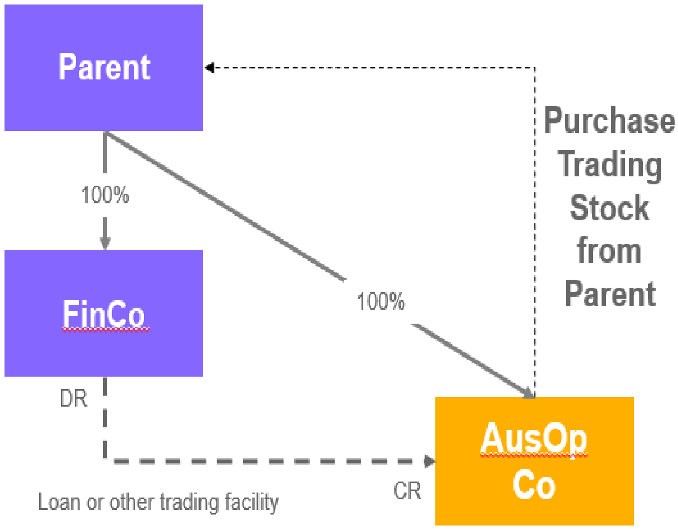
8.2 Example 2 – Facility to buy stock is not exempted (Type 1)

In this example, section 820-423A(1) would apply since AusOpCo is a general class investor, it is not a securitisation vehicle and the conditions in subsection 820-423A(2) are satisfied, as follows:

(a) s820-423A(2)(a) **Acquisition of asset or obligation:** AusOpCo (as the acquirer) acquires trading stock, which is a CGT asset, directly from Parent (as the *disposer*)

(b) s820-423A(2)(b) **Disposer is an associate pair:** Parent is an *associate pair* of AusOpCo, as it holds a controlling stake in AusOpCo

(c) ss820-423A(2)(c) and (d) **Debt related to acquisition of asset**: The borrower (AusOpCo) is the *acquirer* and the debt deduction from the Loan or Other Trading Facility is wholly or partly in respect of the acquisition of the trading stock



(d) s820-423A(2)(e) **Interest paid to associate pair**: AusOpCo's debt deduction under the Loan or Other Trading Facility is referable to an amount paid directly to FinCo. FinCo is an associate pair of an associate disposer as Parent holds a controlling stake in FinCo.

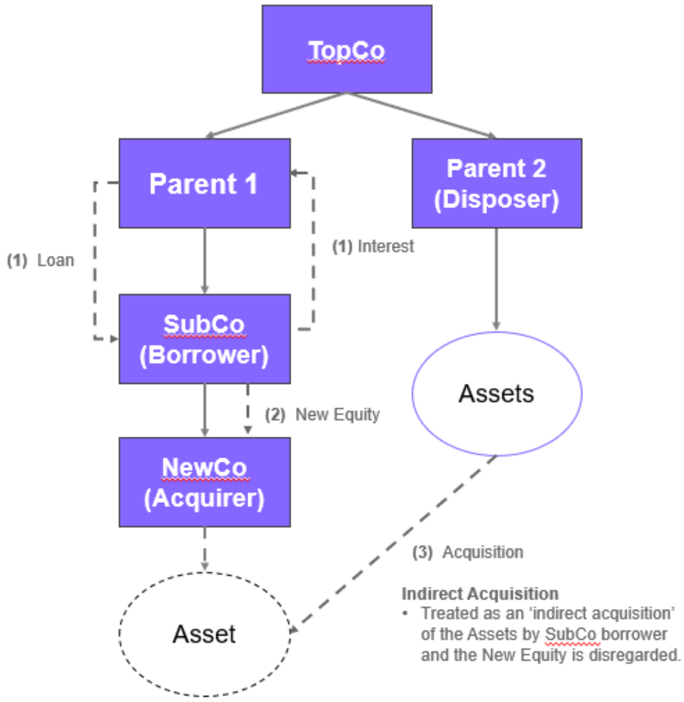
(e) s820-423A(2)(g) **Borrower does not apply TPDT**: AusOpCo has not applied TPDT.

Key comments

The transfer of trading stock is a conspicuous omission from the exceptions in section 820-423AA. This is more so the case given the former debt creation rules included an exemption for trading stock.

It is important to note that the availability of a Loan or Other Trading Facility from a group FinCo to AusOpCo may be provided on arm's length terms. This does not result in the DDCR ceasing to apply to deny deductibility for interest paid by AusOpCo to FinCo. In fact, the incentive created by the DDCR in this example, and in any scenario where there is on-lending within a group where TPDT is not applied, is for the on-lending to be interest free.

8.3 Example 3 – Indirect application of DDCR and interface with exemptions (Type 1)



In this example, Parent 2 has transferred CGT assets to NewCo. NewCo has been funded by new equity issued to SubCo , which has borrowed from Parent 1.

If the analysis is done at the SubCo level and tracing is limited simply to the use of funds by SubCo, it would appear that the DDCR should not apply, since SubCo utilised the Loan proceeds to acquire new equity, which is an excepted transaction under section 820-423AA.

However, as NewCo used the proceeds of the new equity to purchase CGT assets from an associate pair, it is clear from section 820-423A(3A) that the DDCR can apply even though the direct use of the Loan proceeds is to acquire new equity. This is an example of an *indirect acquisition* of the CGT assets from an associate pair Disposer.

Key comments

This example illustrates that tracing the sources and uses of funds carefully is very important. The use of the phrase 'indirect acquisition' can be vague and it is unclear exactly how far tracing is required.

Additionally, while the issue will be one of fact and degree, the following factors are likely to be important in determining whether there is an *indirect acquisition*:

- the timing of the Loan and ultimate acquisition of the assets;
- the tiers of entities through which the proceeds are required to be passed before they are used to indirectly acquire the CGT assets from the Disposer and whether there are any different boards / management / fiduciary duties at the interposed levels which illustrate independent decision making at that interposed level;
- the correlation between the Loan proceeds and the price of the CGT assets indirectly acquired from the Disposer by the Acquirer;
- any connection in the documents or factual matrix between the Loan and the ultimate acquisition of the CGT assets from the Disposer by the Acquirer; and
- whether, in economic substance, the transaction is intended to be an acquisition of the CGT assets.

8.4 Example 4 – Associate pairs and tracing (Type 2)

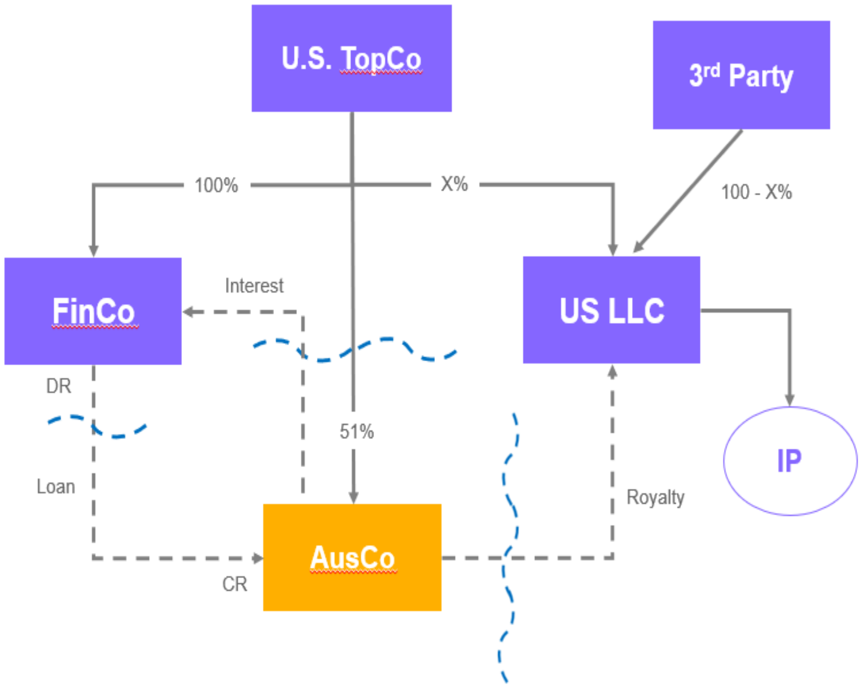
In this example, the application of the DDCR turns on the concept of "associate pair" which is based on the definition of "associate" in section 318 of the ITAA36,[29] treating unit trusts as companies.

The controlling interest test is a bright line test.

However, the "sufficient influence" test continues to be grey and difficult to apply.

AusCo pays to U.S. LLC a royalty funded by a Loan from FinCo.

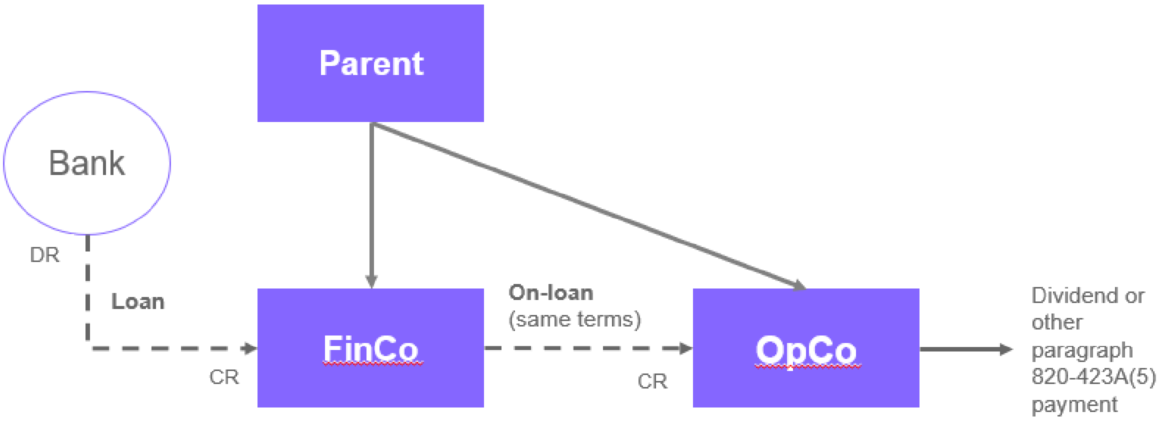
FinCo and AusCo are "associate pairs" as they are both commonly controlled by U.S. TopCo.



However, U.S. LLC will only be an "associate pair" of AusCo if U.S. TopCo and US LLC are "associates" under section 318. This will turn on whether US LLC is a company and if so, the shareholding (X%) and the nature of the arrangements, both formal and informal, between U.S. TopCo and the third party with respect to influence over U.S. LLC. This can involve detailed analysis of the board arrangements, veto rights, voting rights and expectations as to the way in which US LLC will conduct its business. This lack of a bright line test can create significant uncertainty, particularly as the DDCR is essentially an 'all or nothing' test to the extent that the debt deductions relate to the impugned transaction or payment.

[29] Note that, unlike the TPDT or the FRT, the definition of "associate" is not modified to a lower threshold (e.g. 20% TC control interest test for *associate entity* in subdivision 820-EAA).

8.5 Example 5 – Conduit lending must apply TPDT (Type 2)



Conduit financing and TPDT

In this example, despite the Funds being traced to an external debt, this would be an arrangement type 2 and OpCo would be denied a deduction for interest paid to FinCo.

A potential solution would be for FinCo and OpCo to apply the TPDT and rely on the conduit financing rule in sections 820-427B and 820-427C. If the TPDT applies, the DDCR do not apply (paragraphs 820-423A(2)(g) and 820-423A(5)(f)).

Alternative scenarios

Where TPDT is an alternative, there are a number of added complexities to consider, including:

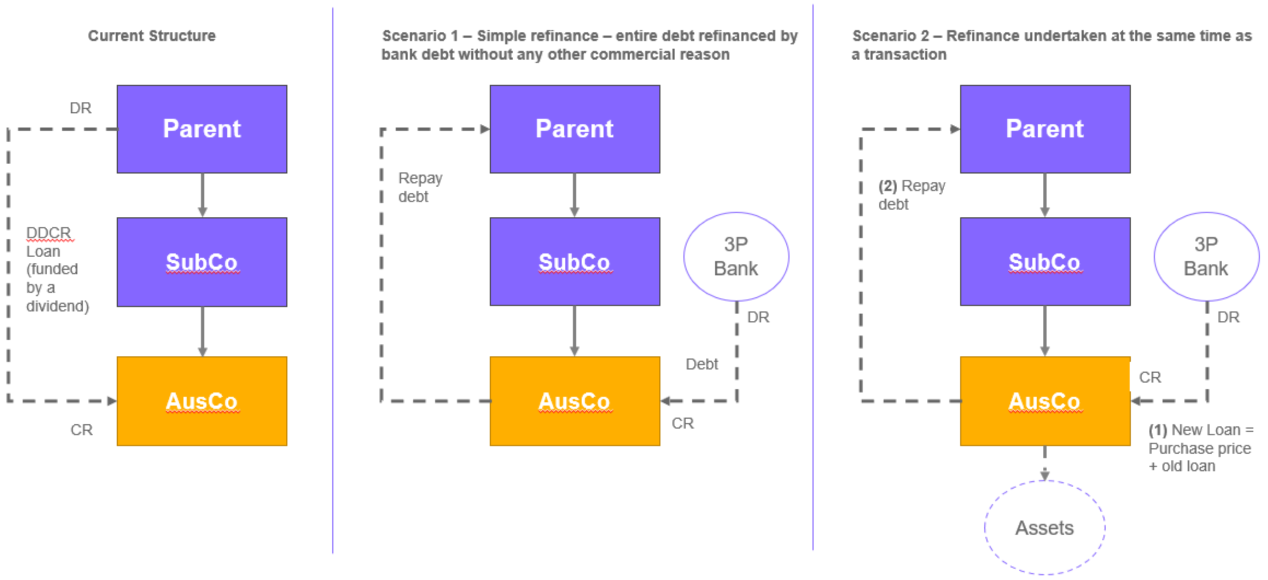
(a) What if OpCo decided to apply TPDT but FinCo did not (noting obligor group rules)?

(b) What if Parent guaranteed the FinCo Loan to Bank? This may cause the debt to fail the third party debt test conditions under section 820-427A(5).

(c) What if Parent formed an income tax consolidated group with FinCo and OpCo – would this permit on-lending?

(d) What if the on-loan did not satisfy the conduit financing rules – say, for example, the interest rate was commercially required to be in excess of the external rate. In these circumstances, there are debt deduction denials in respect of the on-lending under the TPDT as the conduit financing exemption would not apply.

8.6 Example 6 – Restructures to prevent DDCR applying (integrity)



Example 6 is intended to illustrate the potential for the specific anti-avoidance rule to apply.

In Scenario 1, there is a simple refinancing agreement without any commercial reason, other than a desire to retain deductibility. We query whether this would be a high risk refinancing if it would result in a higher headline interest rate and lower net after-tax cost as a result of the deductibility of the interest – that is, the only commercial benefit is the retention of the tax deduction. While it would appear unfair to apply the integrity rule in these circumstances, particularly where the debt was entered into prior to the enactment of the DDCR, it appears to us that there is a significant risk.

In Scenario 2, AusCo purchases a new business and at the same time takes the opportunity to refinance debt to which the DDCR would otherwise apply. It appears to us that this might provide a more robust defence to section 820-423D than Scenario 1.

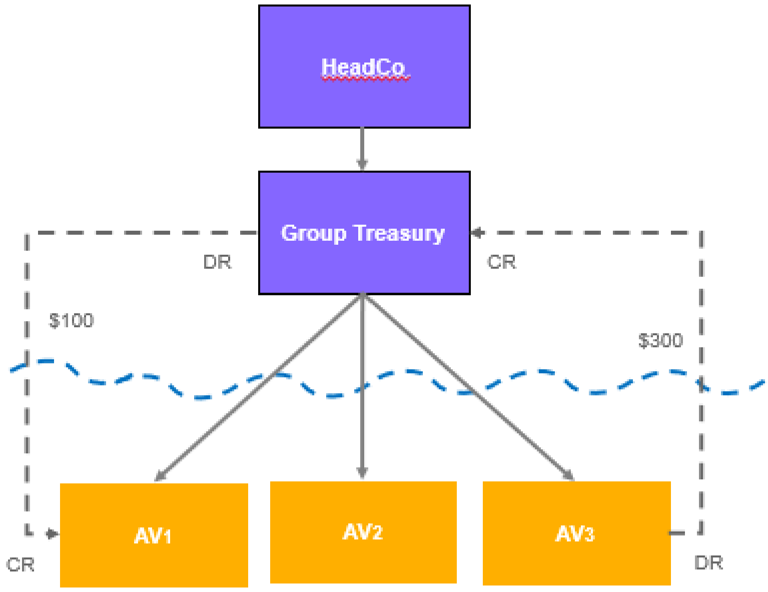
8.7 Example 7 – Cash pools and DDCR (Type 2)

Traditional cash pools

In a traditional cash pool arrangement a group treasury entity maintains loan balances with each member of the pool. Each member either lends to the pool or borrows from the pool.

In these circumstances if AV3 draws down less than $300 to pay a dividend, the DDCR may not apply given it will remain a net depositor with the pool (i.e. the $300 it has lent to the pool is reduced but it will not owe the pool and therefore there is no debt deduction in AV3 to deny).

Compare this to AV1 which will have a DDCR issue if it borrows from the pool, as it is an existing borrower.

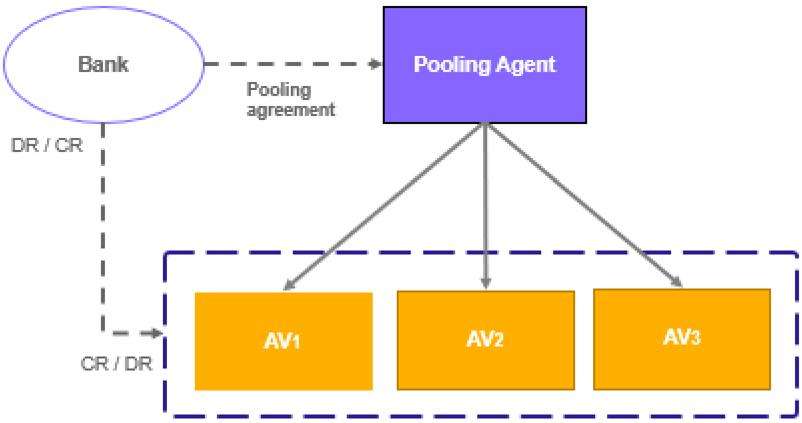


This will require detailed and daily tracing, which will likely impact on the utility of cash pooling in this traditional sense. This is particularly difficult where the Australian entity is part of a larger global group that has cash pooling as a feature of its global treasury management.

Notional cash pooling

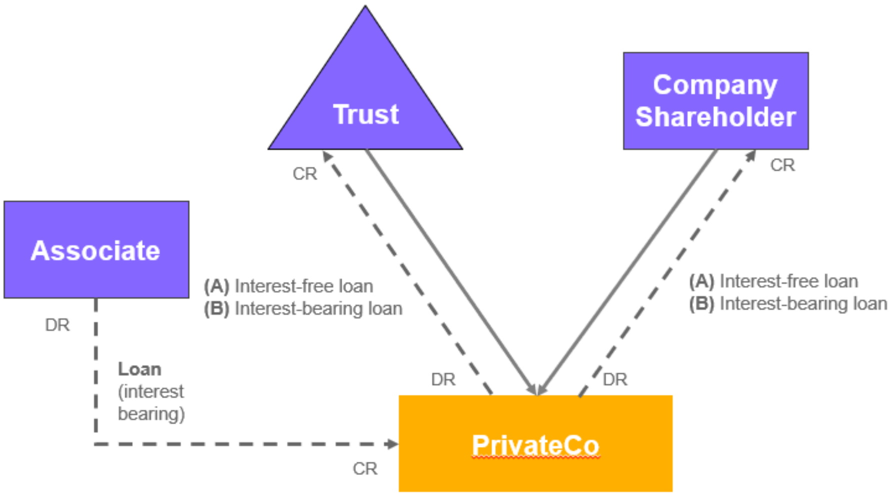
In a notional cash pool, there is no DDCR issue as the loan counterparty is the Bank and not the Pooling Agent. This is the case even if the interest is calculated by reference to net pool balances across the group.

Consequently, cash pooling may still be a viable alternative on a group basis, but it may require the involvement of an external financier to prevent DDCR from applying.



8.8 Example 8 – Division 7A

There are no specific rules in Subdivision 820-EAA to deal with the interaction between the DDCR and Division 7A, including the circumstances set out in this Example 8. The implications mean that extracting cash from private groups which are general investor entities will become more challenging.



The key implications are as follows (assuming either the FRT or GRT are applied by Associate, PrivateCo and Company Shareholder):

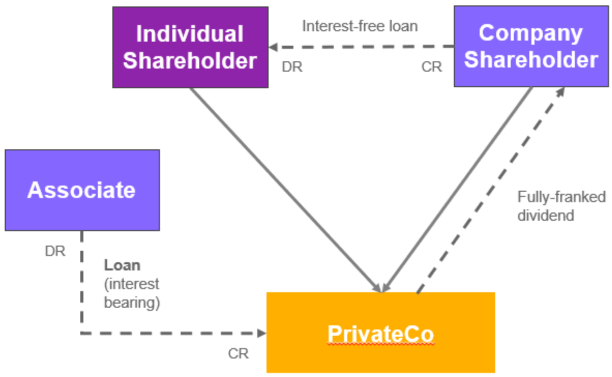
No.	Borrower from PrivateCo	Interest on loan from PrivateCo?	Analysis – DDCR and Division 7A implications
1	Trust	No	The structure is 'hit' twice: ■ Division 7A dividend may result for the Trust as the interest free loan is not on section 109N terms; and ■ DDCR applies to deny PrivateCo a deduction for interest on the Loan from the Associate.
2	Trust	Yes	■ Division 7A can be managed if interest is at least equal to the Division 7A benchmark (regardless of the interest rate on the Loan from Associate to PrivateCo) ; and ■ DDCR applies to deny PrivateCo a deduction for interest on the Loan from the Associate.
3	Company	No	■ No Division 7A dividend – s109K applies (subject to s109T applying – see Example 9); and ■ DDCR applies to deny PrivateCo a deduction for interest on the Loan from the Associate.
4	Company	Yes	■ No Division 7A dividend – s109K applies (subject to s109T applying – see Example 9); and ■ DDCR applies to deny PrivateCo a deduction for interest on the Loan from the Associate.

8.9 Example 9 – Interposed Division 7A scenario

This is a typical section 109T interposed entity arrangement for Division 7A (TD 2018/13) where a payment is passed through an interposed company in order to rely on the exemption from Division 7A in section 109K.

Division 7A dividend and DDCR can apply to the same arrangement at different levels

In this Example, there is both a Division 7A issue (with a dividend taken to be have been paid to the Individual Shareholder) by PrivateCo under section 109T and a DDCR issue for loan between Associate and PrivateCo which has funded the actual dividend to Company Shareholder. This is an example of an arrangement type 2.



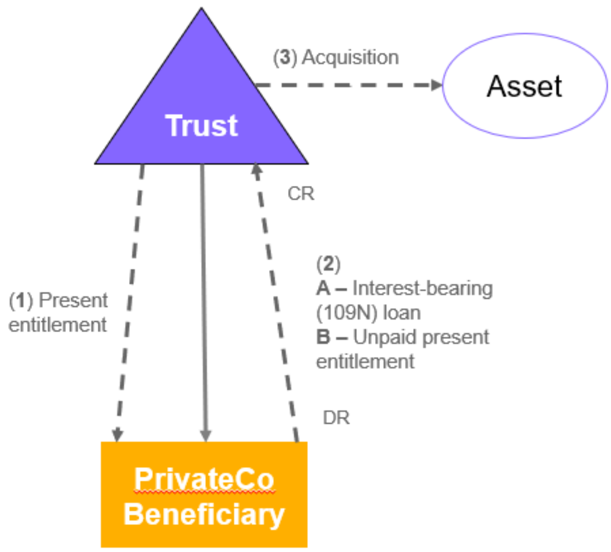
8.10 Example 10 – Section 100A agreement

This example deals with a compliant section 100A agreement (see PCG 2022/2). The Trust makes a PrivateCo Beneficiary presently entitled to income of the Trust (see (1)). The cash is retained in the Trust as either a UPE or placed on complying Division 7A terms (2) and used to fund the acquisition of an Asset from an associate pair of the Trust (3)).

Application of DDCR

The DDCR could apply to the loan between the PrivateCo Beneficiary and Trust if the funds provided to the Trust are used to acquire the Asset from an associate pair. This is clearly the case if the funds are put on complying Division 7A terms, as a loan includes is a *financial arrangement.*

Would the DDCR apply if the complying Division 7A interest-bearing loan was instead a UPE?



If the decision in *Bendel* is upheld and the UPE is not any form of *financial accommodation,* the consequence will be that any returns paid on the UPE (e.g. commercial returns as discussed in TD 2022/11) might not be a *debt deduction* and therefore the DDCR would not apply. This raises interesting questions as to the nature of the *return* on the UPE and in particular whether it can be said to be *economically equivalent* to interest even if there is no underlying debt.

9. Conclusion

The new DDCR rules provide the ATO yet another avenue to treat interest on related party debt as non-deductible. As illustrated in this paper, the breadth of the DDCR can be broad and turn on concepts which have not been precisely defined in either the legislation or the Explanatory Materials.

Further, as the DDCR will apply to all interest deductions post commencement of the DDCR, it will apply to arrangements already in effect and potentially already the subject of rulings by the ATO.

Consideration of the DDCR will need to become a feature of every internal reorganisation and refinancing going forward and almost certainly will mean that debt push downs will become a thing of the past.

The next key developments in relation to the DDCR are issue of ATO guidance in two key buckets – first the guidance on the application of the specific integrity rules in so far as they relate to restructures of existing debt out of the DDCR and secondly in relation to the key aspects of the DDCR (e.g. the meaning of facilitating payments under type 2 arrangements). The guidance is likely to shape the operation of the DDCR and its impact on taxpayers and the use of related party debt.