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Session 2: Navigating the debt deduction creation rules

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1. Introduction

Changes to the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997* (***ITAA 1997***) had been part of the Labor party's tax policy for a number of years before the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024* (***Amending Act***) finally passed both houses on 27 March 2024. Nevertheless, when the Exposure Draft of the *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation* (***ED***) was released in March 2022 and the scope of the changes to the thin capitalisation regime became clear, there was a significant reaction from industry.

One of the more surprising changes to Division 820 was the addition of Subdivision 820-EAA. Subdivision 820-EAA contains the 'debt deduction limitation rules for debt deduction creation (all relevant entities)' (***DDCR***). The DDCR is designed to disallow 'debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification.'[1] However, the scope of the DDCR arguably extends well beyond such arrangements.

The DDCR has been criticised for (among other things), its high compliance burden for taxpayers and application to transactions entered into before the DDCR was introduced. The ATO has issued *Practical Compliance Guideline* 2025/2 (***PCG 2025/2***), which seeks to address some of the practical issues that arise in how the DDCR works.[2]

The Board of Taxation is currently undertaking a review of the rules introduced by the Amending Act, including the DDCR. Such a review was required by the Amending Act itself, presumably as a result of the Treasury's consultation before the Amending Act was introduced.[3] In relation to the DDCR, the scope of the Board of Taxation's review includes considering:

> 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.

This paper will explore some of the issues that arise in navigating the DDCR.

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[1] Explanatory Memorandum to the Treasury Laws Amendment (Making Multinational Pay Their Fair Share – Integrity and Transparency) Bill 2023 (Cth) at [2.146].

[2] PCG 2025/2 at [17]–[43], [67]–[193], [194]–[270].

[3] Such a review was required by Schedule 4 of the Amending Act. The Board will provide its final written report to the Government within 12 months of the review starting.

2. Why did Treasury introduce the DDCR?

Generally, the changes to the thin capitalisation rules were designed to address Chapter 9 of the *OECD's BEPS Action 4* (*Final Report*). The OECD's best practice model suggested moving to the 'fixed ratio rule' and the 'group ratio rule', which is effectively what the Amending Act has achieved. The rationale behind the OECD's position is to address profit shifting through related party interest:[4]

> The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity.

In addition to suggesting the fixed ratio rule and the group ratio rule, the OECD also suggests that some countries may seek to impose 'targeted rules to support general interest limitation rules and address specific risks'[5]. The OECD suggests that targeted rules may be appropriate to ensure there is no anti-avoidance of the general rules and to ensure that entities that are not subject to the thin capitalisation regime also have their interest deductions limited. The OECD provides the following examples of potentially suitable targeted rules:[6]

- An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country.
- An entity makes a payment of interest on an "artificial loan", where no new funding is raised by the entity or its group.
- An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement.
- An entity makes a payment of interest to a related party, which is excessive or is used to finance the production of tax exempt income.
- An entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.

Australia's general anti-avoidance rules, transfer pricing rules and hybrid mismatch rules generally deal with the above.

However, a perceived gap in Australia was in relation to the application of section 25-90 of the ITAA 1997. That provision currently permits an Australian taxpayer to claim a deduction for losses and outgoings incurred in relation to a debt interest, in deriving foreign sourced income where the income is non-assessable and non-exempt (including under the exemption in section 768-5 of the ITAA 1997). Section 25-90 of the ITAA 1997 provides:

> An *Australian entity can deduct an amount of loss or outgoing from its assessable income for an income year if:
>
> (a) the amount is incurred by the entity in deriving income from a foreign source; and

[4] Reer to paragraph 1 of the introduction to the Limiting Base Erosion Involving Interest Deductions and Other Financial Payments - Action 4 2015 Final Report (***Action 4 Report***).

[5] Refer to paragraph 22 of Chapter 1 of the Action 4 Report.

[6] Refer to pages 72-73 of Chapter 9 of the Action 4 Report.

(b) the income is *non-assessable non-exempt income under section 768-5, or section 23AI or 23AK of the *Income Tax Assessment Act 1936*; and

(c) the amount is a cost in relation to a *debt interest issued by the entity that is covered by paragraph (1)(a) of the definition of *debt deduction*.

Both sides of politics had considered either removing section 25-90 of the ITAA 1997 (Labor party[7]) or introducing an integrity rule to reduce the scope of section 25-90 of the ITAA 1997 (Liberal party). However, until the ED, nothing had been done.[8]

In the ED, the Treasury proposed to significantly restrict the application of section 25-90 of the ITAA 1997 by removing the reference to section 768-5 of the ITAA 1997. Following such an amendment, the circumstances in which an Australian company taxpayer could claim interest deductions on a borrowing to invest in a foreign company would be extremely limited. The Treasury was presumably focused on the tax arbitrage that Australian taxpayers can achieve by borrowing in Australia (with the interest deduction generally worth 30 cents in the dollar) rather in the relevant foreign jurisdiction. Given Australia has a higher corporate tax rate than most other countries, this funding structure would be relatively common. The ATO had spent significant resources in the past reviewing whether Part IVA applied to circumstances in which section 25-90 had been used to claim a deduction. See for example *FC of T v Noza Holdings Pty Ltd & Ors* [2011] FCA 46[9] and *Orica Ltd v FC of T* [2015] FCA 1399, and the transactions highlighted in TA 2016/10.

The Treasury received negative feedback when consulting on the ED regarding the proposed changes to section 25-90 of the ITAA 1997. Taxpayers had made a number of material investment decisions in foreign entities on the understanding that a deduction would be available for interest expense.

Following that backlash, and with the Treasury still considering that there was a gap that was not sufficiently covered by the thin capitalisation rules, the amendments to section 25-90 did not appear in the Amending Act[10] and the DDCR rules were instead included. The DDCR rules were loosely based on former Division 16G of the *Income Tax Assessment Act 1936* (***ITAA 1936***). Ironically, Division 16G had been removed when the thin capitalisation rules were introduced, as it was considered that Division 820 of the ITAA 1997 adequately addressed the risks sought to be covered by Division 16G.

The introduction of the DDCR came as a surprise to taxpayers. The Economics Legislation Committee's report on the provisions dated September 2023 noted at paragraph 1.35 that:

> The debt creation rules were completely unanticipated by stakeholders. CPA Australia said that 'like the other 50 submissions, everyone was caught off guard'. They suggested that it was likely a quick replacement or 'a trade-off between deferring 25-90 and putting this in'.

[7] Refer to the May 2013 proposals paper, *Addressing profit shifting through the artificial loading of debt in Australia*.

[8] In the Mid-Year Economic and Fiscal Outlook 2014-15 dated December 2014, the Government announced that it 'would not proceed with a targeted anti-avoidance provision to address certain 'conduit' arrangements involving foreign multinational enterprises, first announced in the 2013-14 MYEFO.' This was on the basis that the changes were 'unrealisable given the flexibility that the thin capitalisation safe harbour limits (which regulates level of allowable debt in Australia of a multinational enterprise) affords for legitimate restructuring'.

[9] The scheme in Orica commenced in 2002, one year after the removal of the former Division 16G of the ITAA 1936.

[10] It is possible that section 25-90 may still be amended in the future, with the EM providing (at Schedule 2) that: Stakeholder concerns regarding section 25-90 were considered by Government, with the proposed amendment deferred, reflected in its removal from the final legislation, to be considered via a separate process to this interest limitation measure.

The Explanatory Memorandum to the Amending Act (***EM***) described the purpose of the DDCR as follows:[11]

> The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.
>
> 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.** (Emphasis added.)

During consultation on the Amending Act, it was put to the ATO that the DDCR was not required as Part IVA of the ITAA 1936 was effective to stop non-commercial lending arrangements. However, the ATO's preference was to have a provision that disallowed debt deductions in relation to such arrangements in the first place, rather than need to rely on (only) Part IVA. The Economics Legislation Committee report dated February 2024 (at paragraph 2.110) notes that:

> Addressing views from some inquiry participants that existing anti-avoidance laws within part IVA of the Income Tax Assessment Act 1936 were sufficient, meaning the debt deduction creation rules may not be required, the ATO said:
>
> > What we would say is that part IVA … is a provision of last resort that is generally better suited to more egregious tax avoidance. In terms of actually achieving the intent of this measure, the underlying intent, I think it is important for something like the debt deduction creation rule to be in place to ensure that that intent is achieved.

The introduction of the DDCR might be a case of 'be careful what you wish for'. In preserving the application of section 25-90 of the ITAA 1997, taxpayers have instead received an administratively complex and far-reaching integrity rule.

[11] EM at [2.145]–[2.147].

3. The statutory Test

3.1 Outline

The DDCR applies in income years starting on or after 1 July 2024. Subdivision 820-EAA only applies to entities that are subject to the thin capitalisation rules and are not exempt from those rules under 820-35 or section 820-39.[12]

Section 820-423A(1) is the main operative provision of the DDCR. It provides:

> (1) This subsection disallows all or part of a debt deduction of an entity for an income year if, for that year:
>
> (a) the entity is any of the following for that year:
>
> > (i) a general class investor;
> >
> > (ii) an outward investing financial entity (non-ADI);
> >
> > (iii) an inward investing financial entity (non-ADI); and
>
> (aa) the entity is *not* a securitisation vehicle; and
>
> (b) subsection (2) or (5) applies

This can be separated into two primary conditions. First, the entity must be an entity to which Division 820 applies (subsections (a)(i)-(iii), and (aa)). Second, subsections (2) or (5) must be satisfied – respectively, the ***Acquisition Limb***, found in section 820-423A(2), and the ***Payment Limb***, found in section 820-423A(5).

If the conditions are satisfied, then the DDCR applies to disallow the relevant debt deduction to the extent provided in section 820-423B (broadly, to the extent the funding is used for impermissible purposes). It is not necessary for there to be any subjective finding of a lack of commerciality or other artificiality (despite what the EM implies the test is aimed at). The denial of debt deductions under the DDCR is not contingent on:

- the purpose of the taxpayer in undertaking the funding arrangement;
- the deductibility of the debt under the reformed thin-capitalisation regime;
- the practical circumstances of the company, save for specific statutory exceptions;
- whether the debt is ultimately funded by a third-party lender;
- the ability for the entity's scheme to be properly classified under the s 815-140 arms-length transaction rules.[13]

There is no provision that provides the Commissioner with the ability to dismiss or 'pardon' a taxpayer's arrangement which has the requisite commercial intention. The rules in section 820-423A operate automatically.

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[12] EM at [2.148]. There are numerous reasons why securitisation vehicles were excluded from the DDCR, which are not discussed in this paper.

[13] Richard Goodwin CTA and Ed Ng, *Changes to the thin capitalisation rules* (November 2023).

The DDCR does not apply if the taxpayer has elected to apply the third-party debt test (refer to sections 820-423A(2)(g) and 820-423A(5)(f) of the ITAA 1997).

The DDCR applies in priority to the general thin capitalisation rules in Division 820. Therefore, if the DDCR applies, such amounts would not be included as a debt deduction for the purposes of applying the fixed ratio test (refer to section 820-31(1) of the ITAA 1997)).

3.2 Acquisition Limb

The Acquisition Limb deals with circumstances where an entity acquires a relevant asset (or obligation) from an '*associate pair*' and incurs debt deductions in relation to the acquisition or holding of that asset. Therefore, the Acquisition Limb is seeking to deny debt deductions that may arise from debt created to facilitate certain intragroup asset acquisitions.[14]

a. The Acquisition Limb will be satisfied when:

b. an entity (the 'acquirer') acquires a CGT asset (or obligation), either directly or indirectly, through one or more interposed entities, from one or more other entities ('disposer(s)');

c. one or more of the disposers is an '*associate pair*' of the acquirer;

d. the relevant entity claiming the tax deduction is the acquirer, or an associate pair of the acquirer or an associate disposer;

e. the debt deduction must be wholly or partly related to the acquisition or the acquirer's holding of the CGT asset (or obligation);

f. the debt deduction method must be directly or indirectly related to an amount paid or payable to an associate pair of the relevant entity, acquirer, or associate disposer; and

g. the acquisition must not be covered by an exception in section 820-423AA.

Section 820-423AA provides an exception for certain CGT assets. These are for three main types of CGT assets which are not covered by the Acquisition Limb, namely:

a. *acquisitions of new membership interests in entities*: where a membership interest in an Australian entity or a foreign company has never been held by a previous entity, such as the issue of a new share in an entity;

b. *acquisitions of certain new depreciating assets:* where the asset is a depreciating asset (but not an intangible asset), that is held by the acquirer immediately after acquisition, which will be used for taxable purposes within Australia, within 12 months, and that asset was not previously installed for use or used by the acquirer, associate disposer, or associate pair; and

c. *acquisition of certain debt interests:* where a debt interest, held by the acquirer immediately after acquisition, is issued by an associate pair, and has not previously been held by any entity (i.e. new loans).

The Acquisition Limb may also apply to indirect arrangements. The acquisition of a CGT asset must be made 'directly or indirectly through one or more interposed entities' (refer to sections 820-423A(2)(a) and 820-423A(3A) of the ITAA 1997). An indirect Acquisition Limb transaction may occur

[14] EM at [2.150].

even if an acquisition in the series is covered by an exception in section 820-423AA. PCG 2025/2 provides (at paragraphs 32 to 33):

> 32. In the case of Type 1 arrangements, the DDCR may apply in relation to an indirect acquisition by an entity through one or more interposed entities. In determining whether an acquisition occurs indirectly through one or more interposed entities, it is sufficient if acquisitions exist between each entity and it is not necessary that these occur in series.
>
> 33. A Type 1 indirect acquisition through one or more interposed entities may occur even if an acquisition in the series is covered by the exceptions in section 820-423AA.

The reference to 'indirect' acquisitions therefore requires a tracing of funds to determine how monies are applied (refer to PCG 2025/2 at paragraphs 161 and 165). The ATO expects the tracing to be evidenced (refer to PCG 2025/2 at paragraph 156).

3.3 Payments Limb

The Payments Limb deals with circumstances in which an entity borrows from an '*associate pair*' to fund or facilitate the funding of a payment or distribution to a relevant '*associate pair*' of the entity. Accordingly, this is seeking to deny debt deductions that may arise from an intragroup borrowing, which is used to fund or facilitate the funding of an intragroup payment. The Payments Limb is intentionally drafted broadly to try and capture various forms of debt creation. The EM provides at paragraph 153:

> The provisions are drafted broadly to help ensure they are capable of applying to debt creation schemes of varying complexity. This approach is necessary given the ability of multinational groups to enter into complex debt creation arrangements.

The Payments Limb will be satisfied when:

a. an entity (the 'payer') enters into, or has a financial arrangement with another entity (e.g. a loan);

b. the payer uses the financial arrangement to fund, or facilitate the funding of payments or distributions covered by section 820-423A(5A) (which covers, among other things, company dividends and distributions, trustee distributions, returns of capital and repayments of principal) to an entity that is an 'associate pair' of the payer;

c. the entity claiming the debt deductions in relation to the financial arrangement is the payer, its associate pair, or an associate pair of the recipient of the distribution; and

d. the debt deduction is referable to an amount paid or payable to an associate pair of the payer, the recipient or (if different) of the entity claiming the debt deductions.

Of note, the phrase 'facilitate the funding' merely requires an indirect connection to be drawn between the use of the financial arrangements, and the funding of the payment or distribution. The Supplementary Explanatory Memorandum to the Treasury Laws Amendment (Making Multinational Pay Their Fair Share – Integrity and Transparency) Bill 2023 (Cth) (***Supplementary EM***) provides at [1.49].

> As mentioned in the paragraph immediately above, section 820-423A(5) requires a consideration of whether the payer uses the financial arrangement to fund, or facilitate funding of, one or more listed payments or distributions. 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.

The Payments Limb may also apply to indirect arrangements (refer to section 820-423A(6) of the ITAA 1997).

3.4 Associate pair

Both the Acquisition Limb and the Payments Limb use the term '*associate pair*', which is based on the definition of '*associate*' in the ITAA 1997. The general definition of an '*associate pair*' is found in division 995-10 and encapsulates circumstances where:

a. the entity is an associate of the other entity; or

b. the other entity is an associate of the entity.

However, section 820-423E provides specific modifications to the definition of associate pair, which only apply in the context of DDCR. The section serves to determine if a unit trust is an associate pair, effectively expanding the scope of the DDCR since a unit trust foundationally does not have separate legal personality. For example, section 820-423E(3) requires the taxpayer to 'treat the trust as if it were a company'.

Treasury also included a '*sufficient influence test*' in relation to such unit trusts. In short, if the following two conditions are met, then the trust will be treated as sufficiently influenced by another entity:

a. the trust is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of the other entity or other entities; and

b. another entity or other entities are taken to hold a majority voting interest in the trust if they hold 50% or more of either:

    i. the income of the trust, represented by the share of income that the other entity, or other entities are entitled; or

    ii. the corpus of the trust, represented by the share of the corpus that the other entity, or other entities are entitled.

3.5 The specific anti-avoidance rule

The specific anti-avoidance rule (***SAAR***) for the DDCR is in section 820-432D(1) and provides:

> (1) Subsection (2) applies if the Commissioner is satisfied that:
>
> (a) it is reasonable to conclude that one or more entities (each of which is a participant) entered into or carried out a *scheme for the principal purpose of, or for more than one principal purpose that included the purpose of, achieving any of the following results:
>
> (i) subsection 820-423A(2) does not apply in relation to a *debt deduction;
>
> (ii) subsection 820-423A(5) does not apply in relation to a debt deduction;
>
> (whether or not the debt deduction is a debt deduction of any of the participants and whether or not any of them carried out the scheme or any part of the scheme); and
>
> (b) the scheme has achieved, or apart from this section would achieve, that purpose.

Importantly, the Commissioner must be 'satisfied that' the particular circumstances apply.

The first circumstance has an objective standard of reasonableness when considering the 'principal purpose' test. The formulation of the principal purpose test in the SAAR also considers circumstances where there is 'more than one principal purpose that included the [impugned] purpose'. The relevant purpose is effectively creating a scheme to avoid either of the Acquisition Limb or Payment Limb.

The EM provides the following examples of when the SAAR might apply:

> 1.43 Schemes that seek to exploit the related party debt deduction condition to artificially locate or 'debt-dump' third-party debt in Australia will be subject to the anti-avoidance rules in section 820-423D and Part IVA of the *[Income Tax Assessment Act 1936.].* For example, such schemes may involve third-party debt (and the associated debt deductions) being located in Australia, whilst the proceeds of the debt are ultimately used for business activities outside Australia. Such schemes may have a sophisticated commercial guise or may be embedded into genuine commercial activity.
>
> 1.44 The anti-avoidance rules in section 820-423D may also apply to any avoidance schemes relating to the debt deduction creation rules. However, these rules are not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules. The application of section 820-423D will ultimately depend on the facts and circumstances of each case.

The reference to 'principal purpose' and the possibility of there being more than one principal purpose in relation to an arrangement is not new (as it appears in the Multilateral Legislative Instrument and the deferred profits tax rules). The ATO has set out its views on how to apply a principal or main purposes test in any of Australia's tax treaties in Practice Statement Law Administration 2020/2. The phrase was also considered in *FC of T v Pepsico & Anor* [2025] HCA 30. Generally, the reference to 'one of the principal purposes' means that obtaining the benefit need not be the sole or dominant purpose of a particular arrangement. An arrangement may have more than one principal purpose and it is sufficient that at least one was to obtain the benefit.

The second requirement is that the scheme must have achieved, or apart from the SAAR would achieve the purpose.

Where the conditions of the SAAR are satisfied, the Commissioner may determine that the DDCR had always had the effect as if the Acquisition Limb or Payment Limb applied in relation to the relevant debt deductions (section 820-423D(2)).

3.6 Documentary support and FIRB

The information and analysis required to support a position is not simple. Anecdotally, we have seen and heard FIRB asking targeted questions regarding a taxpayer's compliance with the DDCR. Some conditions a taxpayer received recently required the taxpayer to provide the following information to Treasury within 90 days:

a. Confirmation whether any CGT asset or legal or equitable obligation will be acquired from an associate pair relating to the Proposed Transaction. If so, state the amount (if any) of debt deductions anticipated to be disallowed under subsection 820-423A(1) in the current and next income year.

b. Within the last six months, have any members of the acquisition Target’s tax consolidated or MEC group, restructured or replaced an arrangement during the income year which would have satisfied the conditions in subsection 820-423A(2) or (5), if the arrangement were still in place on or after 1 July 2024?

c. For each entity, whether any financial arrangement relating to the Proposed Transaction has been or is anticipated to be used to fund or facilitate the funding of a payment or distribution listed in subsection 820- 423A(5A) to an associate pair. If so, state the amount (if any) of debt deductions anticipated to be disallowed under subsection 820-423A(1) in the current and next income year.

d. If neither paragraph (a) nor (b) of subsection 820-423A(5) are anticipated to apply, state the use to which the proceeds of the financial arrangement(s) are to be put.

e. Whether any other associate pairs of each entity are anticipated to issue debt interests in relation to arrangements covered by subsections 820- 423A(2) or (5).

f. Workings that set out the amount of debt deductions disallowed.

g. Provide the rationale and (legal) reasoning as to how the Debt Deduction Creation Rules in Subdivision 820-EAA might apply to your arrangements.

4. Interaction with double tax agreements

4.1 Introduction

A number of Australia's double tax treaties contain a non-discrimination article, the purpose of which is to protect nationals and businesses from tax discrimination in treaty countries. The form of article varies slightly between jurisdictions; the form used in the Australia-New Zealand treaty is adopted below.

Paragraph 4 of the non-discrimination article provides that:

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State in similar circumstances are or may be subjected.

Paragraph 4 is subject to the exceptions provided for in paragraph 5, including relevantly as follows:

> 5. This Article shall not apply to any provision of the laws of a Contracting State which:
>
> a) is designed to prevent the avoidance or evasion of taxes; …

The Australia-New Zealand double tax treaty contains a further clarifying paragraph (paragraph 6), which inclusively defines laws which are designed to prevent avoidance or evasion of taxes for the purpose of paragraph 5. This includes, relevantly:

> a) measures designed to address thin capitalisation, dividend stripping and transfer pricing;

The Explanatory Memorandum to the Australia-New Zealand double tax treaty states that such laws are "commonly accepted by most OECD member countries" as not contravening the non-discrimination article, although Australia and New Zealand saw fit to specifically provide for this.[15]

Paragraphs 5 and 6 are not contained in the OECD Model Convention version of the non-discrimination article. That is, there is no specific override of the non-discrimination article for laws designed to prevent the avoidance or evasion of taxes (or of thin cap rules generally) as there is in certain of Australia's double tax treaties. Several of Australia's bilateral tax treaties follow the OECD Model Convention formulation, however many of Australia's bilateral tax treaties contain similar provisions to paragraphs 5 and 6 of the Australia-New Zealand double tax treaty.

Australia lodged a reservation on the non-discrimination article, to reserve the right to "propose amendments to ensure that Australia can continue to apply certain provisions of its domestic law relating to withholding tax collection".

The non-discrimination article framed the dispute in *G Global 120E T2 Pty Ltd v Commissioner of State Revenue* [2025] HCA 39 (***G Global***). The case concerned the validity of retrospective statutory override to the non-discrimination article to preserve certain State foreign surcharges (with the High Court ultimately upholding the validity of the amending statute). However, the case arose because of a view that certain State foreign surcharges were not chargeable against persons who had the benefit of non-discrimination articles of certain of Australia's double tax treaties, which the High Court accepted as the position prior to the retrospective statutory override.

[15] Explanatory Memorandum to the *International Tax Agreements Amendment Bill (No 2) 2009* (Cth) at [2.344].

4.2 Application for thin cap

The OECD Commentary on Article 24 recognises that the non-discrimination article can apply to domestic rules on thin capitalisation. This is particularly the case with respect to the OECD equivalent of Article 24(3) of the Australia-New Zealand double tax treaty, where it is recognised that domestic rules on thin capitalisation may fall foul of that paragraph insofar as they are not compatible with the associated enterprises article or interest article and which only apply to non-resident creditors (to the exclusion of resident creditors). But the OECD Commentary also recognises that the non-discrimination article can have operation in relation to the OECD equivalent of Article 24(4) of the Australia-New Zealand double tax treaty (extracted above). Specifically, paragraph 79 of the OECD Commentary suggests that thin capitalisation rules which apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents may contravene the non-discrimination article to the extent that the relevant thin capitalisation adjustments are not compatible with the associated enterprises article or interest article. Unlike Article 24(4) of the OECD Model Convention, although there is no express reference to the associated enterprise article or interest article in Article 24(5), the OECD Commentary considers that the paragraph should be read in light of that context of those article appearing in the treaty, applying general principles of treaty interpretation under Article 31 of the *Vienna Convention on the Law of Treaties*.

The OECD Commentary is not detailed in its discussion of the specific circumstances in which thin capitalisation rules might infringe the OECD equivalent of Article 24(4) of the Australia-New Zealand double tax treaty. It has been argued that, on the face of the provision, it may prevent the operation of rules which disallow the deduction of interest paid to non-resident shareholders of companies controlled by non-residents if under similar circumstances, the interest would be deductible for a company which was not controlled by non-residents.[16] In our view, it would be logical for that argument to also apply to rules which disallow the deduction of interest paid to a direct wholly-owned resident interposed company ultimately controlled by non-residents (because such companies would be controlled 'indirectly' by those non-residents) if under similar circumstances the interest would have been deductible for a non-foreign controlled company.

As a side note, there is academic discussion around what is the proper conception of thin capitalisation rules under double tax treaties. On one view, such rules are merely an expression of the principles articulated in the associated enterprises article or interest article, similar to domestic transfer pricing rules and in that regard are considered adjustments to reflect non-arm's length conditions; this is the view adopted by the OECD.[17] On another view, such rules can go beyond what is envisaged by the associated enterprises article as that article does not address the tax treatment of transaction (e.g. deductibility), but only the adjustment of price and recharacterization to reflect arm's length conditions.[18] It is beyond the scope of this paper to offer a view on this discussion, however the comments below largely proceed on a basis consistent with the OECD view.

4.3 Subsection (4)

In the context of the DDCR, there is a question as to whether the rules go beyond what is required by the associated enterprises article and the interest article. If so, then if the DDCR subjects enterprises

[16] OECD Commentary on the OECD 1986 Thin Capitalisation Report at R(4)-17.

[17] L de Broe, 2007, *International Tax Planning and Prevention of Abuse*.

[18] G Maisto, P Pistone and D Weber (Eds), 2016, *Non-discrimination in Tax Treaties: Selected Issues from a Global Perspective* in 'International Tax Law: New Challenges to and from Constitutional and Legal Pluralism' at 57.

controlled (directly or indirectly) by non-residents to more burdensome tax requirements to which other similar, not non-resident controlled, enterprises in similar circumstances, it stands to reason that the DDCR may not be consistent with the non-discrimination article in the OECD model convention.

As noted in the OECD Commentary to the associated enterprises article, the OECD adopts the view that the associated enterprises article:

- does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation; and
- is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital.

The Commentary notes that the application of thin capitalisation rules "should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties".

The DDCR arguably goes beyond what is required by the associated enterprises article and interest article in several respects, including that the rules operate to deny deductions entirely on payments of interest to associated enterprises in respect of loans used to fund payments of dividends or returns of capital to associated enterprises, even where the taxpayer has sufficient head room under the fixed ratio test, and could have borrowed money with an arm's length interest rate from an unrelated financier.

Implicitly, to contend that the DDCR falls within the scope of the associated enterprises article and interest article, it must be that case that the arm's length interest rate on such loans is equal to zero, or that such loans are, in all circumstances covered by the DDCR, properly to be re-characterised as equity, because the DDCR denies interest deductions in their entirety in those circumstances. In our view, this contention is not consistent with generally understood principles of transfer pricing or the arm's length principle.

For completeness, this issue is unlikely to arise in relation to the thin capitalisation rules more generally. As noted above, it is generally accepted that thin capitalisation rules are an expression of, and operate so as to align the profits of an enterprise with the profits that would have accrued in an arm's length situation.

The question, then, is whether the DDCR subjects enterprises controlled by non-residents to more burdensome tax requirements than resident controlled enterprises.

a. On one view, this would be the case, as an Australian resident company that is controlled by Australian residents and which does not have overseas operations should not be subject to the thin capitalisation rules generally or the DDCR. That Australian resident company would generally be allowed interest deductions in relation to relevant related party debt (e.g. debt incurred to finance the payment of a dividend to a related party or to acquire an asset from a related party), provided the requirements of section 8-1 are satisfied.[19] An Australian resident company that is controlled by non-Australian residents would generally be subject to the Australian thin capitalisation rules, however, and would have its interest deductions denied under the DDCR in those circumstances. In *G Global*, the High Court identified the 'taxpayers in similar

[19] See *Commissioner of Taxation v Roberts and Smith* (1992) 23 ATR 494.

circumstances' as being 'Australian enterprises', being 'not a foreign company or trustee of a foreign trust' (to which the surcharge applied).[20]

b. On another view, the position is more nuanced. This is because the DDCR can operate not only with respect to Australian enterprises controlled by non-residents, but also to Australian enterprises (whether or not controlled by non-residents) which control non-resident enterprises (or which have offshore permanent establishments).[21] It is submitted that the issue turns on whether the comparison to resident controlled enterprises "in the same circumstances" requires a comparison to resident controlled Australian enterprises generally, or to resident controlled Australian enterprises which control overseas enterprises. If the former, then it would appear that there is a real issue as to whether the DDCR falls foul of the non-discrimination article, under the OECD model convention. If the latter, then there would seem not to be an issue under the non-discrimination article (except potentially where the non-resident controlled Australian enterprise has no other foreign enterprises in the multinational group), on the basis that such enterprises are subject to the DDCR in the same manner as non-resident controlled Australian enterprises. In this regard, paragraph 7 of the OECD commentary on the non-discrimination article states that the expression "in the same circumstances" refers to taxpayers "in substantially similar circumstances both in law and in fact".

4.4 Savings provision

As noted above, many of Australia's double tax treaties contain specific provisions which override the non-discrimination article for laws designed to prevent the avoidance or evasion of taxes (or of thin cap rules generally). For these treaties, it is not merely sufficient to demonstrate that the DDCR is inconsistent with the text of Article 24(5) of the OECD treaty (in its Australian treaty equivalents); it must be the case that the DDCR falls outside those specific override provisions. Accordingly, it is relevant to consider whether the DDCR is a law "designed to prevent the avoidance or evasion of taxes" and, for certain treaties, whether the DDCR is a "measure designed to address thin capitalisation".

As a starting point, unless the context otherwise requires, terms that are not defined in Australia's double tax treaties have the meaning that they have under the laws of the respect contracting states for the purposes of the taxes to which a double tax treaty applies (see Article 3(3)). That is – Australia would interpret the savings provisions by reference to the meaning its terms have under Australian law.

There is no objects provision contained in the DDCR which articulates the purpose for which the rules were designed. Section 820-423 describes the rules in passing as being simply "debt deduction limitation rules".

The EM for the Amending Act explains (at paragraphs 2.144 to 2.147) that:

> 2.144 Excessive debt deductions pose a significant risk to Australia’s domestic tax base.
>
> 2.145 The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate

[20] G Global at [41].

[21] Refer to definition of general class investor.

> entity. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.
>
> 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.

On its terms, the EM states that the DDCR is a set of 'supplementary rules' which addresses issues which the strengthened thin capitalisation rules 'do not address'. Rather, the key object of the rules appears to be mitigating the risk of base erosion and profit shifting in relation to 'excessive debt deductions' generally. This is consistent with the commentary in paragraphs 173 and 174 of the OECD BEPS Action 4 Report, referenced in the Explanatory Memorandum, which states that targeted rules may be required 'to address base erosion and profit shifting risks' both in relation to entities which are not subject to general interest limitation rules, and those which are.

This description, and the examples of specific base erosion and profit shifting risks, contained in paragraphs 173 and 174 of the OECD BEPS Action 4 Report, suggest that the kinds of targeted rules contemplated (which formed the basis of the DDCR) are not directed at addressing entities which are thinly capitalised, but go to a broader concern about artificial debt deductions. For example, paragraph 173 specifically calls out:

- an entity <u>which would otherwise have net interest income</u> enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country;
- an entity makes a payment of interest on an "artificial loan", where no new funding is raised by the entity or its group;
- an entity makes a payment of interest to a related party, which is excessive; and
- an entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.

The DDCR can therefore deny debt deductions for a taxpayer even where the taxpayer has sufficient headroom under the fixed ratio test and so would not otherwise be considered thinly capitalised for the purpose of the thin capitalisation rules. By its practical operation, the DDCR does not deny deductions on the basis of whether a taxpayer is thinly capitalised – a taxpayer remains otherwise able to incur debt deductions up to the fixed ratio test limit - but by whether it has entered into a transaction which is considered to give rise to specific base erosion issues. Accordingly, it is tenuous whether it could be said that the DDCR is in fact 'designed to address thin capitalisation' for the purpose of Article 24(6).

If that is the case, the question becomes whether the DDCR is a law "designed to prevent the avoidance or evasion of taxes" more generally. It is unclear whether it is correct to say that the DDCR is designed to prevent the avoidance or evasion of taxes, by its practical operation or in its legislative intention, or by express statutory requirements. In short, this is because of the practical operation of the DDCR resulting in the DDCR applying to many kinds of schemes (including those described elsewhere in this paper) which have genuine commercial justification, and a lack of any express avoidance or evasion purpose requirement contained in the rules.

As noted above, the EM states that the DDCR is designed to apply "in relation to debt creation schemes that lack genuine commercial justification". However, the DDCR may apply in circumstances which go well beyond "schemes which lack genuine commercial justification". There is no 'purpose' requirement, of a kind contained in Part IVA, and there is no obvious reason or general principle which suggests that schemes which involve related party borrowing to fund the acquisition of assets from related parties to fund the payment of distributions to related parties always lack genuine commercial justification. To suggest otherwise would imply that Part IVA should apply to such schemes as a matter of course to a taxpayer that is not subject to the thin cap rules. Of course, it is well accepted that Part IVA can have application to such schemes, but only where they further lack a genuine commercial justification (and thus satisfy the dominant purpose test in section 177D). Indeed, many schemes which are captured by the DDCR are otherwise consistent with the arm's length principle.

The EM refers to paragraphs 173 and 174 of the OECD BEPS Action 4 Report, which might suggest that Parliament viewed schemes which fall within the ambit of those paragraphs as lacking genuine commercial justification. Again, however, the DDCR applies far more broadly than the kinds of schemes described in paragraph 173. Nor do the schemes to which the DDCR can conceivably apply bear the same level of contrivance or artificiality of those described in paragraph 173.

Although not containing an express reference to the non-discrimination article, it is telling also that paragraph 174 of the report states that such additional targeted rules "should ideally be applicable to all entities, irrespective of whether they are also subject to the fixed ratio rule and group ratio rules. However, these rules are particularly important where an entity is not subject to a fixed ratio rule…".

4.5 Conclusion

All things considered, the application of the non-discrimination article in the OECD model convention and in Australia's bilateral tax treaties to the DDCR is unclear. However, as outlined above, there is a real question as to whether the rules could fall foul of the non-discrimination article, which warrants further consideration. If the DDCR was inconsistent with the non-discrimination article, this could result in taxpayers which are controlled by residents of countries with which Australia has concluded a relevant double tax treaty not being subject to the DDCR.

5. Previous schemes identified by the ATO – would the DDCR catch them?

As noted in part 2, one of the reasons that Treasury wanted to introduce the DDCR (if section 25-90 were not repealed) is to significantly reduce the circumstances in which the ATO would challenge claims for interest deductions in relation to related party transactions. This has effectively been done by removing the deduction in the first place, which means that the ATO would not need to apply Part IVA to reduce or remove the claim for an interest deduction. *Noza Holdings* and *Orica* are examples of the kind of transaction that the DDCR is aimed to prevent from arising. In this part 5 we examine how the DDCR would apply to the same facts, if the DDCR had been enacted at the time.

5.1 Noza Holdings

Noza Holdings concerned an intra-group transaction undertaken by a multi-national group. The transaction was aimed at centralising the ITW Inc[22] group's ownership of its customer based intangibles, thereby facilitating any future legal action for their protection and giving rise to state tax savings in the US. This involved the creation of various royalty income streams (valued at $4 billion) and their transfer for value between companies in the ITW Inc group.

The two Australian entities involved in the transaction were CSA Pty Ltd (***CSA***) and ITW AFC Pty Ltd (***AFC***). AFC was a wholly-owned subsidiary of CSA, and itself wholly owned Solutions Group Transaction Subsidiary Inc (***SGTS***), a US resident company.

The matter primarily involved whether Noza Holdings Pty Ltd (***Noza***) (which became the head entity of a MEC group on 1 December 2002 which included CSA and AFC) was entitled to a tax deduction under section 25-90 of the ITAA 1997 in respect of a distribution paid by CSA to CS Financing I LLC (***CSFI***) under a redeemable preference share (***RPS***) that was a debt interest for income tax purposes. The payment under the RPS was ultimately funded from a distribution paid by SGTS to AFC under a separate RPS.

The key facts are as follows:

a. CSA, a member of the Noza MEC group, issued RPS to CSFI. The RPS were a debt interest and returns on the RPS would give rise to 'debt deductions' for thin capitalisation purposes.

b. AFC issued RPS to CSA. In the context of consolidation, that transaction would have been ignored. However Noza had not formed a tax consolidated group at that time.

c. CSFI transferred a 'royalty stream' to AFC for consideration. The royalty stream was the right to receive the royalty income under various intra-group sub-licences. In exchange for this, AFC endorsed the US$1 billion demand note (which had been originally issued by CSF) back to CSFI. The US$1 billion demand note was then cancelled by CSFI. AFC also issued a US $3 billion purchase note to CSFI.

[22] In 2001, ITW Inc and its wholly owned subsidiaries (collectively the ITW Group), operated some 600 decentralised businesses in over 40 countries, principally concerned with the manufacture and sale of a wide range of consumer and industrial products.

d. AFC then transferred the 'royalty stream' to SGTS in return for the issue of $1 billion of RPS and SGTS taking on AFC's obligations in relation to the US $3 billion purchase note.

The net impact of the transaction (from the perspective of the Noza MEC group) was that:

a. SGTS had issued RPS of $1 billion to AFC. This was an equity interest owned by AFC.

b. AFC had issued RPS of $1 billion to CSA (which would be ignored under the single entity rule when the entities were part of a tax consolidated group).

c. CSA had issued RPS of $1 billion to CSFI. This was a debt interest from CSA's perspective.

d. SGTS then ultimately held the relevant royalty streams and owed CSFI an amount of approximately $3 billion.

SGTS signed a promissory note in the amount of $222,655,981, in satisfaction of a dividend payment by SGTS to AFC on 15 November 2003. Much of the *Noza Holdings* case concerned the tax characterisation of this aspect of the transaction, however it is not necessary to examine the dividend here.

The Full Federal Court held that a deduction was available under section 25-90 in part[23] for the dividend of $222,655,981 paid by CSA to CSFI.[24]

Would this transaction have been caught by the DDCR had it happened today?

In relation to the Acquisition Limb, the question should be examined by reference to the totality of the arrangements including the royalty stream that was acquired by AFC from CSFI and ultimately transferred to SGTS. In this regard:

a. The Noza MEC group (i.e. AFS) (being the acquirer) acquired the 'royalty stream' from CSFI (being the disposer). The Noza MEC group (also AFC) acquired RPS from SGTS (being the disposer).

b. All of the entities were wholly-owned and therefore would satisfy the association and common ownership requirements.

c. On a tax consolidated basis, the entity claiming the tax deduction for the purposes of section 820-423A(1) is the acquirer (i.e. Noza, as head company of the MEC group). The debt deduction (being amounts paid on the RPS issued by CSA to CSFI) was paid to an associate pair.

d. The next question is what were Noza's debt deductions 'in relation to'? Were they incurred in relation to the acquisition of the royalty stream or the RPS issued by SGTS?

    i. The preferred view is that the debt deduction was 'in relation to' the royalty stream acquired by AFC from CSFI, as the consideration for the issuance of the RPS was applied to acquire the royalty stream. The royalty stream would be a CGT asset because the royalty stream was a contractual right. The exception in section 820-423AA(2) of the ITAA 1997 for the transfer of depreciation assets (if the royalty stream were such) would not apply because the

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[23] The reason that the deduction was only available in part had regard to the particular economics and terms of the RPS that had been issued.

[24] At first instance the Federal Court also considered whether Part IVA applied to remove the deduction. Gordon J held that the Part IVA did not apply, primarily because there was no tax benefit. The Commissioner did not appeal in relation to the application of Part IVA and therefore that issue was not considered by the Full Federal Court.

royalty stream was intangible. Note that AFC promptly disposed of the royalty stream to SGTS. Therefore at the time Noza claimed the deductions, there was no relevant asset owned. However this should not prevent the Acquisition Limb from being satisfied as the borrowing could still be regarded as being 'in relation to' the acquisition' of the royalty stream.

ii. Another perspective would be that the debt deduction was 'in relation to' the acquisition by AFC of the RPS from SGTS, reflecting the net position of the IWT group following completion of all of the transactions. In these circumstances, the exception in section 820423AA(3) for newly created debt interests should apply.[25] AFC subscribed for newly created securities, and did not obtain a transfer of a pre-existing CGT asset. However, this is not the preferred view because of the intervening transfers of the royalty streams (discussed above).

Therefore the Acquisition Limb is likely to be satisfied.

In relation to the Payments Limb, the relevant borrowing is from CSFI. The RPS issued by CSA to CSFI should be a financial arrangement for the purposes of this provision, as the RPS gave rise to an obligation by CSA to pay dividends and ultimately redeem the shares. In order to satisfy the Payments Limb, the Noza group would have had to use the borrowing to fund a payment covered by section 820-423A(5A). For the purposes of paragraph (5)(b), the payments or distributions may be made directly, or indirectly through one or more interposed entities, and before, at or after the time the payer enters into or has the financial arrangement.

The list of payments captured by the Payments Limb in section 820-423A(5) is broad. The payment for the royalty stream would only come within section 820-423(5A) if AFC made a payment for a 'royalty, or a similar payment or distribution for the use of, or right to use, an asset'. While there is not a lot of detail regarding the royalty stream in *Noza Holdings*, none of the parties appear to have actually paid a royalty or any other payment for the use of intellectual property. Accordingly, it seems unlikely that the Payments Limb would apply.

5.2 Orica Ltd v Commissioner of Taxation [2015] FCA 1399

Taxpayer Alert TA 2016/10, which was referred to during the consultation on the DDCR,[26] contains a simplified example of the *Orica* case.

The central issue in *Orica* was whether Part IVA of the *ITAA 1936* applied to a cross-border financing arrangement. Orica's US subsidiary, Orica US Services Inc (***OUSSI***), had made loans to one of Orica Limited's (***Orica***) Australian subsidiaries, Orica Finance Limited (***OFL***). Under the arrangement, OFL claimed deductions under section 25-90, or alternatively section 8-1, of the ITAA 1997 for interest paid by OFL to OUSSI (which had significant carried-forward US tax losses).

The funding for the loan made by OUSSI to OFL originated from a subscription for redeemable preference shares that OUSSI had received from a third entity in the Australian Orica group (Orica Explosives Holdings Pty Limited (***OEH***)), which was part of the Orica tax consolidated group.

[25] Under section 820-423AA(1) the acquisition of a CGT asset is excluded from the Acquisition Limb if the CGT asset is a membership interest in an Australian entity or foreign company, and the membership interest has not previously been held by any entity. However, the RPSs were debt interests and therefore not membership interests (refer to the note in section 96-135).

[26] Refer to TLAB Multinational-003: Answers to written questions on notice asked by Senator Jess Walsh during Public Hearing on 15 August 2023 - Australian Taxation Office (received on 22 August 2023).

OFL applied the borrowing from OUSSI to make a loan to OEH, such that there was no net cash outflow.

With the exception of a US$48,999,338 dividend paid on the redemption of the Series B Redeemable Preference Shares, no dividends were paid to OEH on any of the preference shares issued by OUSSI under the scheme.

The ATO decision impact statement provides the following summary of the tax benefit received in the US.

> OUSSI conducted Orica's North American explosives business. It had incurred significant operating losses and had consequently accumulated US tax losses in the years leading up to the scheme. The losses had initially been recognised in Orica's consolidated balance sheet as a Future Income Tax Benefit (FITB) asset for US purposes. However, under the Australian accounting standards, to maintain recognition of the value of the FITB in Orica Limited's subsidiary, the FITB had to be 'virtually certain' it could be used in the future. Given OUSSI's protracted poor financial performance, the FITB asset was written off in 2001.
>
> The scheme caused OUSSI to receive income that was assessable in the US. This enabled re-recognition and use of the US tax losses. Orica re-recognised the losses over a period of three years. In 2006, when the US losses had been fully used, the arrangement was unwound.
>
> …
>
> The expert evidence before the court was that the scheme improved the reported profits over the re-recognition period. The three consequences of the arrangement were:
>
> • a cumulative reduction of A$33.8m in the income tax expense recognised on the payment of interest by OFL to OUSSI
>
> • an increase of $45m in the income tax expense of OUSSI, and
>
> • a cumulative reduction in the income tax expense of OUSSI, equal to the increased amount, by bringing into account the unbooked benefits of the tax losses.

The Commissioner brought proceedings to disallow this deduction.

Pagone J held that section 177D applied to disallow the deductions. This was due to a combination of several factors.

a. First, his Honour held that even though an aspect of the loans was to contribute funds into the US Orica group, "the relevant transaction was structured to have, *as an essential element*, deductions being obtained by the Orica group in Australia".[27]

b. Secondly, Pagone J found that the interest rates on the loans "were governed by group policy and were not the product of arms-length bargaining" such that the transaction, as a whole, "was not commercial, and was not intended to produce anything but a loss to OFL".[28]

c. Thirdly, the transactions were entered into by members of a group of companies who were wholly controlled by their parent company where "the scheme brought no lasting advantage to the group other than from the tax saved by domestic deductions for the interest".[29] Therefore, Part IVA applied.

The DDCR is not likely to apply to the facts of *Orica*, had the DDCR been enacted at the time.

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[27] *Orica Ltd v Commissioner of Taxation* [2015] FCA 1399, [21] (emphasis added).

[28] *Orica Ltd v Commissioner of Taxation* [2015] FCA 1399, [22].

[29] *Orica Ltd v Commissioner of Taxation* [2015] FCA 1399, [22], [31].

In relation to the Acquisition Limb, OEH (the acquirer) acquired a CGT asset (being RPS) from OUSSI (the disposer). The entity claiming the deduction is Orica (as head company of the tax consolidated group that includes both OFL and OEH. The key question is whether the debt deduction claimed by Orica is 'in relation to' any CGT asset acquired by the Orica group. In a broad sense, the transactions are interdependent, and it might be concluded that the debt deductions would be 'in relation to' OEH's subscription for RPS in OUSSI, as OFL's borrowing from OUSSI effectively funds that subscription. However, even if the debt deductions were 'in relation to' the acquisition of the RPS, it is likely that such acquisition would be excluded under section 820-423AA(1) as the RPS were new debt interests.

Further, the Payments Limb would not be likely to apply on the basis that the borrowing by OFL does not appear to facilitate the funding of any payments or distributions to a related party. Although the loan from OUSSI to OFL could be construed (more broadly) to be assisting OFL in making their initial loan to OEH, OUSSI's funding only supports OFL *making* the loan to OEH, rather than OEH *repaying* OUSSI. Such a payment is not contemplated in section 820-423A(5A).

Note that the funds received by OUSSI were in part used to repay a loan previously made by OFL to OUSSI (as well as making the loan to OFL). It is possible that this repayment would mean that there had been an indirect funding of a relevant 'payment', being the repayment of principal under a debt interest issued by OFL. However, the repayment of principal is not to an associate pair of OFL but rather comes back to OFL following completion of the circular transaction.

It would be expected that Part IVA, not the DDCR would continue to be used to deny the deduction in *Orica*.

6. Cash pooling

A cash pooling arrangement is typically an arrangement under which group entities pool their cash balances in a single group company for the purpose of short-term liquidity management. Under the pooling arrangement, the bank account balance of each pool member is transferred daily to a single master bank account owned by the group cash pooling entity. Any group entity account in deficit is brought to a balance of zero by transfer from the master bank account to the bank account in deficit.

This cash sweeping process is generally carried out through automatic processes of the nominated bank and accounting entries of the fund transfers between the cash pooling entity and other group members are posted daily. Group members are typically able to draw down on the cash pooling facility on demand, and do so to fund most if not all of their cash requirements. To comply with transfer pricing requirements, drawings typically bear interest, and conversely group members with a positive balance will generally earn interest on that balance.

Cash pooling arrangements typically allow taxpayers to maximise investment returns, by concentrating the group's funding, to streamline the operation of trading, settlements and account, and to centrally manage and monitor credit risk, counterparty risk, liquidity risk and operational risk.

Example 6 of PCG 2025/2 confirms the risk of the DDCR applying to cash pooling arrangements in the usual course. In that example, the ATO constructs a typical cash pooling arrangement, with an offshore cash pooling entity, similar to that described above. In Example 6, the relevant taxpayer has no other borrowings, and uses its cash pool account to acquire CGT assets from associate pairs and to fund dividends, royalties and returns of capital to associate pairs. The ATO confirms that, where debt deductions arise for an income year, taxpayers need to consider the application of the DDCR in respect of those debt deductions and that the ATO is likely to consider applying compliance resources to verify the correct application of the DDCR for that income year.

Cash pooling arrangements are particularly challenging from a DDCR perspective. This stems largely from the fact that a taxpayer needs to draw down on the cash pooling facility to have sufficient cash to pay dividends or returns of capital to its shareholders (who often will be associate pairs), and to cash purchase assets from an associate pair. In the context of the Payment Limb, this means that it is often difficult to establish that the taxpayer did not use the cash pooling facility to fund a relevant dividend or return of capital, because (absent changes to the usual operation of the cash pooling arrangement) ordinarily cash drawn from the cash pooling facility would be directly applied to pay the distribution.

The verb 'fund' is not defined in the DDCR, nor does the EM provide more insight into Parliament's intended meaning. Accordingly, the term 'fund' should take its ordinary meaning. The Macquarie Dictionary defines the verb 'fund' to mean, relevantly, 'to provide a fund to pay the interest or principal of (a debt)' and 'to raise or provide money for'. Having regard to the context of section 820-423A(5), the term 'fund' implies a direct connection between money, and the use to which that money is put. Determining whether a cash pooling arrangement has 'funded' a payment of the kind set out in subsection (5A) should therefore be a relatively straight forward determination. Where cash drawn from a cash pooling facility is directly applied to pay a distribution, this should be viewed as 'funding' for the purpose of the Payment Limb.

Even where the cash drawn from the facility is not directly applied to pay a distribution, but is instead applied towards working capital expenditure, thus freeing up other operational cash to ultimately pay the distribution, there remains a risk that the cash pooling arrangement 'facilitated the funding' of the distribution. The Supplementary EM explains that the phrase 'facilitate the funding' requires an indirect connection between the use of the financial arrangement and the funding of the payment or distribution (e.g. because the use of the financial arrangement can reasonably be said to have allowed for, directly or indirectly, the funding of the payment or distribution).[30] Arguably, the connection between the mere freeing up of other operational cash and the payment of a distribution out of that cash is too indirect and attenuated to attract the operation of the DDCR primary rule. The effect of the contrary interpretation would be that a taxpayer could never pay a dividend, or return capital, to an associate pair shareholder where it borrowed money from an associate pair at any time.

The ATO's position is that taxpayers should use tracing wherever possible to determine disallowable debt deductions.[31] The ATO acknowledges, however, that apportionment may be needed where it is not possible to trace, provided the method adopted by a taxpayer is fair and reasonable. Example 17 of PCG 2025/2 describes an appropriate instance of apportionment in a cash pooling arrangement, where debt is issued through a cash pooling arrangement to fund the payment of a dividend, and then refinanced through another debt interest from a different associate pair in the same group.

The SAAR would need to be considered in the context of any such attempts to disconnect the use of the cash pool facility with the funding or facilitation of the funding of a relevant distribution. This is because often it could be difficult for a taxpayer to establish a strong commercial purpose for the use of the account absent to ensure that the Payment Limb does not apply in connection with the distribution. However, the risk of the SAAR applying should be reduced to the extent that (1) the arrangement requires less material deviations from the existing cash pooling arrangements; (2) the overall balance of the cash pooling facility is reduced over the course of the income year; or (3) the use of the separate bank account gives rise to operational benefits or ease of paying the distribution, or allows the taxpayer to time the distribution to align with more favourable market or FX conditions.

Another question that arises in the context of cash pooling facilities is whether the cash pooling facility as a whole should be the relevant 'financial arrangement' or each drawing under it. The term 'financial arrangements' takes its meaning from the TOFA rules in Division 230. If the cash pooling facility as a whole is the relevant financial arrangement, then the DDCR should be applied through that lens; alternatively, a taxpayer would need to consider what each drawdown of the cash pooling facility funded or facilitated the funding of.

The case of *Foley v Hill* [1843-1860] All ER 16 stands for the proposition that a bank account is a single debt existing between the customer and the banker in their respective capacities as creditor and debtor. The case did not consider bank accounts with an overdraft or drawdown facility for the account holder. The proposition was recognised in Example 2.6 of the Explanatory Memorandum to the TOFA rules. There it was noted that:

> the right to receive the balance of the bank account is therefore taken to be one right. However, that right is in relation to each dollar that comprises the balance of the account. Each dollar is a financial benefit and hence for the purposes of TOFA the customer is taken to have a separate right to receive each dollar that comprises the balance of the account.

In that Example, the bank account was treated as a single financial arrangement for TOFA purposes, having regard to the factors in section 230-60(4). Further, in TR 2012/4 at [163], the Commissioner suggests that where in a facility agreement, or overdraft account, interest is paid on the total current outstanding balance, this will tend to suggest aggregation of a single financial arrangement.

On the contrary, in ATOID 2006/230, although concerning the identification of the relevant 'debt interest' under Division 974, the Commissioner ruled on the facts of that ATOID that each respective drawdown under a facility agreement passed the debt test in section 974-20, and that the facility agreement itself was not treated as a debt interest under Division 974.

Ultimately, however, not much may turn on the question, as the DDCR denies debt deductions by reference to the extent to which the relevant financial arrangement funded an impermissible payment

[30] Supplementary EM at [1.49].

[31] PCG 2025/2 at [164]-[170].

or asset acquisition. Accordingly, even in circumstances where a cash pooling facility is aggregated as a single financial arrangement, this would likely correspond with a lower proportion of funding applied towards an impermissible purpose (with a corresponding reduction to the proportion of debt deductions denied).

7. Restructuring

Restructuring or unwinding arrangements in response to debt deductions enlivening the DDCR risks triggering integrity rules and engagement with the Commissioner. Considerations of these integrity rules, such as the SAAR and those in Part IVA of the ITAA 1936, are vital to future restructures. The scope of permissible restructuring lies in the extent to which the arrangement maintains the same level of debt deduction that would have existed but for the DDCR. Blackwood and Mifsud observe that it does seem that the Commissioner is not trying to harm taxpayers who are doing the right thing to comply with the rules, or those who are just restructuring:

> the EM indicates that this rule will not apply to *"merely restructuring"* out of an arrangement that would otherwise trigger the DDCR *"without any associate artificiality or contrivance"*… [T]he ATO said: "… *as a general principle… [it]… would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law*".[32]

PCG 2025/2 provides insight into the Commissioner's risk framework of restructures made in response to the DDCR. The framework operates by classifying restructures into white/yellow/green/red risk levels that drive the intensity of ATO engagement.[33] Green and red risk levels denote low-risk and high-risk restructures respectively. White indicates that no further risk assessment is required because the matter has been resolved through a settlement with the ATO, a court decision on the tax outcomes, or an ATO review or audit that assigned a low-risk rating. Yellow applies where a restructure is not addressed by PCG 2025/2, in which case the Commissioner may engage with the taxpayer to assess the compliance risks associated with the arrangement. Risk classification appears commensurate with the difference between the hypothetical debt deduction engaging the DDCR and the debt deduction arising from the restructure. This means the scope to restructure is narrowest where the restructure appears designed to preserve a similar level of deductions notwithstanding the DDCR.[34]

Restructures are only deemed low risk by the Commissioner where the arrangements are otherwise commercial.[35] PCG 2025/2 specifies the following features must be present for a restructure to be low risk:

a. Debt deductions disallowed by the DDCR prior to the restructure have been accurately calculated;

b. Prior to the restructure, the arrangements would not have attracted the application of Part IVA of the ITAA 1936;

c. The restructure occurs in a straightforward manner having regard to the circumstances, without any associated contrivance or artificiality and is on arm's length terms; and

d. The arrangement following the restructure will not otherwise attract the application of Part IVA of the ITAA 1936.[36]

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[32] Cameron Blackwood and Simon Misfud, *Session 13 Debt deduction creation rules – searching for clarity* (13-14 June 2024) p 22.

[33] PCG 2025/2 para 50–52.

[34] Ibid 199–203, 250–252.

[35] Ibid 202.

[36] Ibid.

These features closely resemble those specified by PCG 2018/7 in respect of low-risk restructures of hybrid mismatch arrangements.

Examples of low-risk restructures are identified by PCG 2025/2. These include restructures repaying temporary shareholder bridging debt repaid after external financing secured,[37] related-party acquisition refinanced with third-party debt to eliminate DDCR,[38] disposing of foreign assets by liquidating a foreign subsidiary with no capital gain or loss on the liquidation;[39] and related-party debt repaid via equity injection and termination of interest rate swaps.[40] The common theme in the identified examples is the refinancing of arrangements in a manner that is generally commercial and does not replicate a similar debt deduction that would have existed but for the DDCR.

By contrast, high risk restructures arise where new arrangements maintain a similar level of debt deductions that would have existed prior to the DDCR while serving no commercial purpose.[41] The aim of this enforcement strategy is to preclude taxpayers from using the third party debt test under subsection 820-46(4) with the purported effect of circumventing the DDCR.[42] PCG 2025/2 identifies three examples of high risk restructures:

a. A related-party debt used to pay a dividend subject to DDCR is factored between subsidiaries to recharacterise its use, creating risk the restructuring misrepresents underlying funding purpose and associated interest deductions; [43]

b. A related-party debt used to acquire an asset from a related party is refinanced with third-party debt while the offshore group repays equivalent debt, facilitating high-risk Australian 'debt dumping';[44]

c. An Australian company engages in circular funding steps by issuing related-party debt ostensibly to repay third-party borrowings but immediately redrawing to fund equity injections into a loss-making subsidiary acquiring related-party assets, creating a high-risk mismatch between the asserted and substantive use of funds and attracting DDCR denial.[45]

The commercial rationale for restructuring is the determinative factor for engagement with the Commissioner. Restructures using third-party debt to preserve debt deductions otherwise arising between associate pairs through arrangements with no commercial purpose are more likely to attract the SAAR and Part IVA of the ITAA 1936. For example, a restructure is regarded as low risk where an Australian economic group replaces related-party debt which it cannot service with an equivalent amount of third-party debt, because the group thereby incurs genuine external interest expenditure and the refinancing is not accompanied by any broader group reorganisation, back-to-back or connected financing arrangements, or any reduction in third-party debt held elsewhere within the group. By contrast, the same refinancing becomes high risk where an Australian entity repays the debt of its foreign associate using third-party borrowings, but the foreign associate contemporaneously uses those funds to repay its own external debt, producing the practical effect of reallocating existing group debt into Australia. Although both scenarios involve refinancing

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[37] Ibid 209-211.

[38] Ibid 215-219.

[39] Ibid 226-230.

[40] Ibid 232-235.

[41] Ibid 250-251.

[42] Ibid 251.

[43] Ibid 254-257.

[44] Ibid 260-264.

[45] Ibid 266-270.

related-party acquisition debt with third-party borrowings following the application of the DDCR, the former reflects a substantive increase in group-wide external debt to respond to the commercial needs of the company, whereas the latter evidences a mere reallocation of debt that undermines the policy intent of the DDCR by facilitating uncommercial 'debt dumping' rather than a genuine change in the group's economic position.

Ambiguity persists over the treatment of restructures not designated as low-risk or high-risk which fall in the 'yellow' risk zone. This zone occupies the intermediate space between clearly low-risk and clearly high-risk restructures under PCG 2025/2. A yellow classification does not imply non-compliance or the application of anti-avoidance provisions; rather, it reflects that the Commissioner has not yet assessed the compliance risk of the arrangement. In this zone, the Commissioner may engage with the taxpayer to obtain further information and to understand the commercial rationale, funding flows and economic substance of the restructure.

8. Conclusion

In practice, the DDCR operates as a bright-line integrity rule that can deny deductions in transactions that are commonplace in multinational groups (including internal reorganisations, financing of distributions and cash pooling), regardless of whether the arrangement is otherwise arm's length or commercially driven. It is not clear whether the taxpayer community (that lobbied for section 25-90 of the ITAA 1997 to remain) regrets the compromise that they have been given with the DDCR. The Board of Taxation's review provides an opportunity to calibrate the rules, so they better target artificial debt creation while reducing compliance costs for ordinary business funding.