Corporate Tax Association

Level 11, 455 Bourke Street
Melbourne, 3000

Tel: (03) 96004411
admin@corptax.com.au

8 November 2024

Mr Stephen Dodshon
Acting Assistant Commissioner – New Measures
Australian Taxation Office
GPO Box 9990
SYDNEY NSW 2001

By email: stephen.dodshon@ato.gov.au

Dear Stephen,

RE: Draft PCG 2024/D3 – ATO compliance approach to thin capitalisation changes and debt deduction creation rules (DDCR)

The Corporate Tax Association (**CTA**) welcomes the release of *Draft Practical Compliance Guideline PCG 2024/D3 Restructures and the new thin capitalisation and debt deduction creation rules – ATO compliance approach* (**draft PCG**). As we have noted in previous correspondence, the timely development of public advice and guidance is important for the effective administration of and compliance with the amendments.

The ATO's approach in developing the draft PCG is welcomed. The permissive nature of guidance is integral to providing certainty and lowering the overall compliance burden of taxpayers while alleviating pressures on the ATO's private rulings program.

To support the ATO's development of the final PCG, the attachment to this letter provides commentary and recommendations that fall into the following five categories:

1. Dealing with the potential overlap between sections 820-423A(2) and (5),
2. Recalibration of compliance zones, particularly the white and green zones,
3. Further examples that the ATO may consider in Schedule 1,
4. The need to provide examples and further commentary in Schedule 2 as to when section 820-423D (the DDCR SAAR) may or may not be of concern, and
5. Tracing and apportionment considerations and methodologies.

We would welcome the opportunity to discuss the contents of this letter with you further. If you wish to arrange a meeting, please contact me at sstaples@corptax.com.au.

Yours sincerely,

Simon Staples
Assistant Director

1. Dealing with the overlap of subsections 820-423A(2) and 820-423A(5)

We note that from paragraphs 17 to 29 the draft PCG deals with the bifurcation of acquisition (Type 1) and payment and distribution (Type 2) cases. We note that there may be an unintended overlap of subsection 820-423A(2) with subsection 820-423A(5) which may mean the policy-based carve-outs applying to subsection 820-423A(5) are ultimately ineffective (as arrangements sought to be excluded under subsection 820-423A(5) are still inadvertently captured under subsection 820-423A(2)). In our view, this needs to be dealt with in the draft PCG.

For example, while the acquisition of a debt interest as a CGT asset is excluded from subsection 820-423A(2) for the *lender* by operation of subsection 820-423AA(3), the legal or equitable obligation "acquired" by the *borrower* when entering into/issuing the same debt interest is not explicitly excluded. Consequently, on one interpretation of the law, an entity borrowing from a related party can have interest deductions denied under 820-423A(2), even when the borrowed funds are used for a purpose that is neutral under the regime (e.g. payment of salary costs, deposit with an external financial institution, etc). A similar outcome could potentially apply where related parties merely enter into a financial derivative arrangement, such as an interest rate swap.

Our understanding from Examples 7 and 8 of the draft PCG is that the ATO proposes a sensible "look through to the underlying transaction" approach for the application of section 820-423A(2) to related party borrowings and financial derivative arrangements. That is, the legal or equitable obligations acquired by a payer pursuant to a related party financial arrangement are not themselves acquisitions that are covered by 820-423A(2). Rather, the section focuses on what the related party financial arrangement has been used to fund or relates to.

As such, where a related party borrowing or financial derivative relates to a transaction that is not covered by section 820-423A(2), the debt deductions in respect of the related party borrowing or financial derivative are not covered (as per Example 7 in the draft PCG). Similarly, debt deductions in relation to a related party financial derivative that relates to a transaction that is covered by section 820-423A(2) will be subject to the DDCRs (as per Example 8 in the draft PCG).

It would be beneficial for the ATO to include specific commentary when finalising the PCG to make this interpretation of the law explicit.

Example

AUS Parent is an Australian listed company and is the head company of a tax consolidated group of which AUS Finance Co is a member. AUS Finance Co acts as the treasury entity for the global group. Foreign Co is a non-Australian subsidiary of AUS Parent. Foreign Co is profitable and USD funds from its earnings are placed on deposit with AUS Finance Co and attract an arm's length interest rate.

AUS Finance Co uses the USD received from Foreign Co initially to deposit in its USD bank account with an unrelated bank and subsequently on operational spending with unrelated parties.

While subsection 820-423A(5) should not apply to the borrowing by AUS Finance Co from Foreign Co, because the borrowed funds are used for wholly for operational spending or investment with

unassociated entities[1], subsection 820-423A(2) may apply, as the key elements seem to be satisfied, including:

- Acquisition of CGT asset (foreign currency) [2] by an Australian entity (AUS Finance Co) from an associate pair (Foreign Co),
- Australian debt deductions relate to the acquisition of that CGT asset from an associate pair,
- Australian debt deductions relate to interest that is payable to an associate pair (Foreign Co), and
- no exception in section 820-423AA applies to AUS Finance Co (noting that subsection 820-423AA(3) is not satisfied because AUS Finance Co does not *acquire* a debt interest, but is the *issuer* of a debt interest).

Clarification on how the inappropriate overlap of subsections (2) and (5) will be avoided, as well as the scope of 'legal or equitable obligation[s]' intended to be caught under subsection (2), is crucial to achieving certainty in the practical application of the rules.

[1] And, specifically, not any payment covered by 820-423A(5A)

[2] Alternatively, or in addition, there may be an acquisition of a legal obligation by AUS Finance Co from Foreign Co, namely the obligation to repay the foreign currency. In this case the subsequent requirements can also be modified *mutatis mutandis* to relate to the obligation.

2. Recalibration of compliance zones

In our view, the delineation of white, green, yellow and red zones needs to be consistent with approaches adopted in other PCGs, including for example [PCG 2017/4](). The following suggestion takes into consideration the differing compliance/assurance approaches that are adopted in various taxpayer markets to assess risk (in particular assurance-type reviews undertaken under the Top 100 and Top 1000 Justified Trust program).

Changes to the White Zone

We suggest the current wording in paragraph 33 of PCG 2017/4 dealing with white zones should be adapted to define the white zone in the current draft. The aim is to reflect that risk and assurance reviews that happen under the Justified Trust program should be treated as being in the "white zone" rather than the green zone where they have received a low risk or high assurance rating during that process.

Paragraph 53 could be replaced with the following marked up version of paragraph 33 of PCG 2017/4:

> *"You are deemed to be in the white zone and do not need to self-assess the risk rating of your ~~related party financing arrangement~~ DDCR restructure where:*
>
> *(a) any of the following apply to your restructures in response to the DDCR since 8 April 2024:~~apply to a related party financing arrangement~~ for the current year*
> *~~(i)an advance pricing arrangement (APA)~~*
>
> > *(i)a settlement agreement between you and us*
> > *(ii) a court decision, and*
> > *(iii)we have conducted a review (including any assurance review under justified trust processes) of your ~~related party financing~~ restructuring arrangement (where the review commenced on or after 8 April 2024 ~~1 January 2015~~) and provided you with a low risk or high assurance rating for your restructure ~~financing arrangement~~."*
>
> *~~AND~~*
> *~~(b)~~*
> *~~there has not been a material change in the conditions of the related party financing arrangement including the terms, pricing, global group funding arrangements, comparability factors~~ are part of the "white zone"*
> *~~and/or risks since the time of the agreement, decision or review.~~*

Changes to the Green Zone

Paragraph 59 should be correspondingly adjusted to reflect that low risk and/or high assurance ratings should be in the white rather than the green zone as follows:

> *"You are in the green zone if all of your restructures in response to the DDCR are in the following categories:*
>
> - *Your restructure in response to the DDCR in the income year is*
>   - *covered by low-risk examples in Schedule 2 to this Guideline, and*
>   - *exhibit the features set out in paragraph 166 of this Guideline.*

- ~~*We have conducted a review or audit of your restructure and*~~
  - ~~*provided you with a 'low-risk' rating (or 'high assurance' under a Justified Trust review), and*~~
  - ~~*there has not been a material change in the arrangement which informed the basis of our risk or assurance rating in the review or audit*."~~

3. Changes to Schedule 1

Schedule 1 provides 11 examples of when (and when not) it may be necessary to consider the operation of the DDCR. In our view the examples are very useful, but ,we suggest, will provide better clarity if they are separated into two categories:

a) Category 1 being examples where the ATO will not apply compliance resources (as opposed to "unlikely to apply compliance resources"), and
b) Category 2 being examples where the ATO is likely to apply compliance resources.

This naturally leads to Category 2 transactions/arrangements possibly being restructured. As such these could fall for consideration under Schedule 2 as either low risk or high risk restructures where such restructures are undertaken.

In our view this could be achieved by bifurcating Schedule 1 as follows:

	Category 1 – ATO will not apply compliance resources	**Category 2 – ATO likely to apply compliance resources**
Examples	1,2,4,5,7	3, 4 (para 98), 6,8,9,10,11

Clarity on Example 1 for unincorporated joint ventures

Example 1 in the draft PCG implies that unincorporated joint venture arrangements result in the joint venture parties being associate pairs. It should be made clear that the joint venture parties must be associates as defined in section 318 of the *Income Tax Assessment Act 1936* (**1936 Act**) to be considered an associate pair.

To be an associate pair in the DDCR, the relevant entities must be 'associates' as defined in section 318 of the 1936 Act. This means that the joint venture parties would have to be in a tax partnership (as a minimum) and in receipt of income jointly to meet the section 318 definition. In Example 1, the parties are 'tenants in common' and TR 93/32 states that co-owners of rental properties are tax partnerships because they jointly receive rental income. However, most unincorporated joint ventures, particularly in the mining and oil and gas sector, do not constitute tax partnerships since they are not in receipt of income jointly and therefore the joint venture partners are not associates of each other, by virtue of the joint venture relationship.

Examples building off Example 2 in the draft PCG

We would also suggest that further examples that build off Example 2 are needed. For example, where:

1. Aus Co and all its Australian subsidiaries are part of a tax consolidated group to draw out the ATO's views on whether the borrowing solely to fund Gold mine 2 is somehow funding or facilitating the funding of the dividends paid from Aus Co to B Co.

We note that the legal entities and their boards in a tax consolidated group are all acting independently of each other from a legal and governance perspective and are not part of the tax fiction that is the single entity rule.

2. Debt funding may exist beyond the development stage in Gold mine 2 and confirmation that the debt is not funding or facilitating the funding of the dividends paid from Aus Co to B Co. The change in status of the mine from development to operational has not changed the purpose of the original debt funding to develop Gold mine 2.

3. A taxpayer accumulates some of their revenue in a separate bank account to fund dividend payments. As a consequence, it needs to borrow from a foreign related party to fund some of its opex and capex, as it does not have enough cash flow to fund both.

4. A taxpayer draws down on its debt facility in year 1 but the investment in Gold mine 2 does not occur until a later year.

In our view, the additional examples for your consideration in 1 to 4 immediately above should not require further ATO compliance resource allocation.

Examples building off Example 3 in the draft PCG

We would also suggest that further examples that build off Example 3 are needed. One specific example is where a debt instrument is refinanced where the original debt instrument had previously had a portion of debt deductions subject to the DDCR. This can be built off Example 3 in the draft PCG where using the same fact pattern as the base, the following occurs:

- The original debt interest (**loan 1**) of $100 million between Aus Co and B Sub Co is due to expire.
- Aus Co and B Sub Co agree to refinance the debt interest for $100 million for a further 9 years (**loan 2**).
- No further dividends paid were funded by loan 2.

In applying the DDCR to loan 1, Aus Co would only need to consider the application of the DDCR for the extent to which the financial arrangement funded or facilitated the funding of the dividends to B Co. In this case, Aus Co would need to determine (via tracing and apportionment) what portion of the debt deductions attributable to the payment of a dividend would be denied under the application of the DDCR with respect to loan 1.

When loan 1 is refinanced in full, Aus Co will then need to consider the application of the DDCR to loan 2 to the extent (or partly referable) the funds of loan 2 relate to the payment of the original dividend to B Co. That is, Aus Co would need to determine what portion of debt deductions arising under loan 2 is attributable to the payment of a dividend that was in part funded by loan 1, with only that portion of the debt deduction being denied under the application of the DDCR with respect to loan 2.

The portion of debt deductions arising under loan 2 that fund the commercial operations of Aus Co will not be subject to the application of the DDCR.

In addition to the above, further consideration should also be given to additional examples where:

1. A taxpayer borrows from a related party to make an equity injection into a non-wholly owned subsidiary to fund its business. That subsidiary uses some of the proceeds received to pay a dividend.

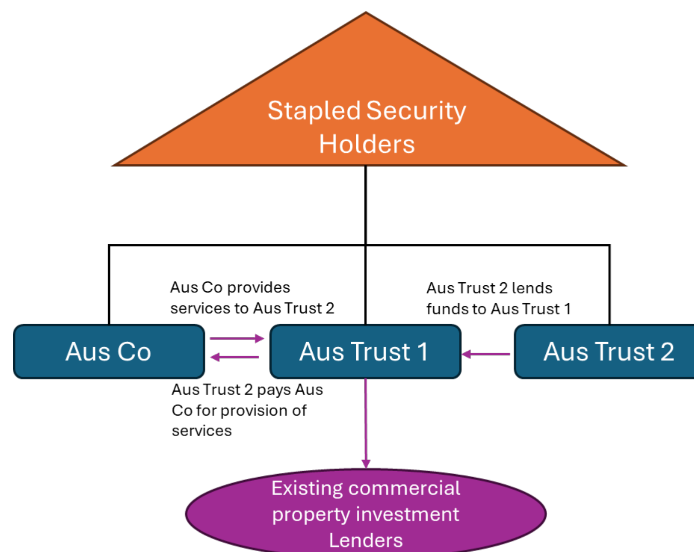
2. A taxpayer intends to pay a dividend but needs to partly borrow to do so. It has borrowing capacity on a cross-border related party loan but instead borrows externally at a higher interest rate to pay the dividend. The external borrowing also has a s128F WHT exemption.

In our view, these may require ATO compliance resource allocation.

Additional examples not previously provided

As a result of the ATO releasing the draft PCG, some additional examples have been provided to us that warrant the ATO's consideration. While these may be viewed as a variation to examples provided, the nuances of the DDCR mean that taxpayers are seeking certainty on how the ATO may seek to apply the rules.

Funding capital expenditure that ***enhances*** *an existing CGT Asset*



In this example, Aus-Co, Aus-Trust 1 and Aus-Trust 2 are Australian tax resident members of a stapled group and are general class investors. Aus-Trust 1 and Aus-Trust 2 are unit trusts and after applying the modifications in section 820-423E Aus-Co, Aus-Trust 1 and Aus-Trust 2 are associate pairs.

Aus-Trust 1 owns a commercial property asset which was acquired from an unrelated third party. Aus-Trust 1 contracts with Aus-Co for the provision of design and construction services to redevelop

the commercial property asset. Aus-Trust 1 borrows from a related party to pay for the design and construction services.

The payments made by Aus-Trust 1 to Aus-Co for the services are not prescribed payments or distributions covered by subsection 820-423A(5A).

The redevelopment results in Aus-Trust 1 acquiring new depreciating assets that are covered by the exception in subsection 820-423AA(2).

The redevelopment also results in Aus-Trust incurring capital costs which give rise to deductions for capital works under Division 43. These capital costs enhance the value of the commercial property investment but do not give rise to a separate CGT asset.

In our view, Aus-Trust 1 will not need to consider the application of the DDCR for this arrangement as the arrangement does not result in the acquisition or holding by Aus-Trust 1 of a CGT asset nor a prescribed payment that is covered by the DDCRs.

4. Changes to Schedule 2

Paragraphs 158 to 162 should make it clearer that Schedule 2 provides the ATO view on the operation of both Part IVA and section 820-423D on the restructuring of existing and future arrangements that would have debt deductions denied under section 820-423A(1).

Paragraph 204 notes contrived arrangements to “choose and use the TPDT with the purported effect of preventing the DDCR applying”. In our view, inclusion of examples of this in the draft PCG would be useful and can include the following:

1. Aus Co is looking to acquire a line of trading stock from a related party Warehouse Co. However, to acquire new trading stock Aus Co needs to obtain working capital. At the time, Aus Co could have secured funds from US Parent Co at an arm’s length rate as US Parent Co had surplus available to be used by the global group. However, Aus Co decided to finance the acquisition of trading stock using a third-party debt facility at a slightly higher interest rate due to the higher costs associated with external unrelated debt.

   In our view, section 820-423D should not apply in these circumstances merely because there was an option to use related party finance, but the decision was made to secure finance from an unrelated bank due to the application of the DDCR. In other words, optionality should not warrant the application of section 820-423D or Part IVA in these circumstances.

2. Taxpayers that bifurcate cash from business activities from their related party borrowings and trace the use of funds. Inclusion of views on whether the act of bifurcating funds and tracing so that future potential blacklisted acquisitions are not debt-funded is necessary. This should include views on borrowing to working capital and other capex but using cash reserves to pay related party dividends.

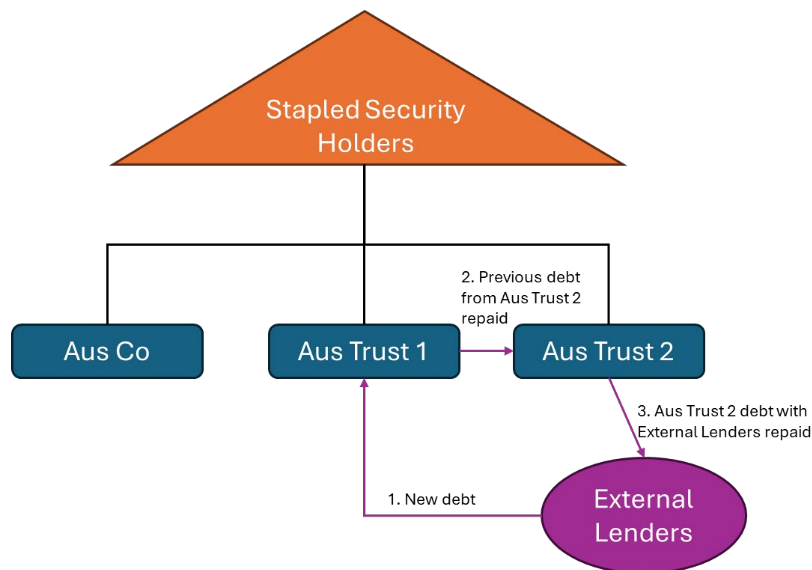
3. Borrowings from a third party financier to fund a pre-acquisition dividend to a related party.

4. Where a taxpayer replaces an existing internal financial arrangement with a comparable external financial arrangement because the historical information does not exist to determine and/or evidence a transaction with a suitable degree of certainty (noting the tax record keeping requirements that were relevant at that time a transaction was undertaken and the obligation to lodge true and correct returns for the 2025 income tax year), whether or not the deductions under the arrangement are impacted by the DDCR consistent with the statements in paragraph 1.44 of the Supplementary EM that *“… these rules [the anti-avoidance rules] are not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out or an arrangement that would otherwise be caught by the debt deduction creation rules.”.*

5. Restructures undertaken by taxpayers prior to the commencement of Subdivision 820-EAA where the effect of the restructuring is reflected in the assessment of later years.

Refinancing Australian-related party debt with third party debt

We observe there will be instances where simply borrowing from a third party to repay debt will not be considered debt dumping. In our view, the PCG should include an additional example as a variation of example 19 in the draft PCG which we consider to be low risk. One such example of this scenario is set out below.



In this example, Aus-Co, Aus-Trust 1 and Aus-Trust 2 are Australian tax resident members of a stapled group and are general class investors. Aus-Trust 1 and Aus-Trust 2 are unit trusts and after applying the modifications in section 820-423E Aus-Co, Aus-Trust 1 and Aus-Trust 2 are associate pairs.

In a prior year, Aus-Trust 1 acquired a commercial property for $100 million from an associate pair. Aus-Trust 1 borrowed $100 million from Aus-Trust 2 to fund this acquisition.

Shortly before the commercial property acquisition, Aus-Trust 2 had borrowed amounts from external lenders. Aus-Trust 2 used some of these borrowings to fund the $100m loan to Aus-Trust 1. The balance of the external borrowings was used to fund Aus-Trust 2's assessable income-producing activities.

Aus-Trust 1 determines that the DDCR may apply to its debt deductions in relation to the acquisition of the commercial property asset.

Aus-Trust 1 repays its $100m debt, funded by borrowing $100 million from unrelated lenders. Around the same time, Aus-Trust 2 repays $100m worth of debt owed to unrelated lenders. The restructure does not increase or decrease the overall debt level of the Australian stapled group. It merely restructures the Group's debt such that both Aus-Trust 1 and Aus-Trust 2 have borrowings from external lenders.

In our view, this is a low risk restructure.

5. Tracing and apportionment considerations and methodologies

While we recognise the law requires the tracing of funds to determine whether the debt deductions associated with that debt are, or are not, deductible, and that apportionment technically applies where funds may have dual purposes, in our view the draft PCG needs to determine practical "flags in the sand" where it is not possible to trace or where funds are mixed as debt is fungible.

It should not be forgotten that since the removal of the old debt creation rules in Div 16G of the ITAA 1936, taxpayers as a practical matter did not need to trace funds, but rather relied on the thin capitalisation rules to determine non-deductibility of debt deductions. This historical reality should be acknowledged. We submit some sort of acceptable practical apportionment should be seen as a means to best approximate a tracing exercise to reflect this reality that has been in place for decades. This still addresses the policy decision to apply the DDCR to arrangements in place before 1 July 2024.

In this respect, we note the following observations made by the current Commissioner in relation to the question of tracing and section 25-90:[3]

> *Senator MILNE: That is a long way of saying that Treasury changed its mind in terms of its recommendation in relation to repealing these provisions. Why wouldn't we have just repealed the provisions and addressed the other side of the argument? The only reason you would keep something like that is that it did not prevent people carrying out legitimate business, which is what you have just said. Why did we not just address that separately, rather than leave this in here? It is increasingly costing the taxpayer. What is it actually costing us? What is your projection on what it will cost by keeping it?*
>
> *Mr Heferen **:** Very little. In the unfortunate world of public policy and public policy advising, we do it in reasonably constrained environments; but you learn a lot of things when you go through consultation. Originally the government, back in November 2013, announced that there were a range of things that the previous government had on the books and also that the Howard government had on the books as far as tax goes that it would not proceed with, some it would proceed with and some it would change. The 25-90 one was one that would change. What it said was, 'What we will do is not proceed, but we will explore a targeted anti-avoidance provision.'*
>
> *We then worked it through with the Tax Office. On the ones that we were actually worried about, there were seven or eight identified. As was worked through quite closely, what we then found was that actually all of those ones that we were worried about would have the facility to restructure and still claim whatever deduction they could. They were large enough and sophisticated enough to have sufficient debt to fund their Australian operations and sufficient equity to fund their foreign operations. They would have to do some tracing of the funds. So there were some an extra compliance costs, but for these large corporations it was probably not much.*
>
> *As it turned out, the revenue that we at one stage thought would be obtained from that was a mistake. Really, there was no upside with proceeding. The measure would have only had downsides, because what it would have done was prevent legitimate activity taking place. It was one of those very salutary lessons for people like me and people who work with me in our jobs. We realised what seemed like a good idea at the time turned out to be not what we thought, largely because of the capacity of the firms—which we thought the arrangements were targeting—to be able to get around what was being provided*

[3] Corpoarte Tax Avoidance Inquiry Hearing 9 April 2015

While we acknowledge the draft PCG indicates certain apportionment methodologies that are not acceptable in paragraph 156, the draft doesn't provide permissive guidance on methodologies that the ATO may consider fair and reasonable other than saying it depends on the facts and circumstances of the case. With respect, this doesn't provide much in the way of practical guidance. The onus is on the taxpayer to have records to prove that the DDCR has no application. Therefore, acceptable methodologies must be provided in the PCG to enable taxpayers to comply with this record keeping requirement.

It would be beneficial for the draft PCG to set out what factors the ATO considers necessary to determine what is a fair and reasonable methodology. We note the ATO has provided guidance on this in the context of GST apportionment for financial supplies.

Any suggestions could be supported with examples that also set out the type of methodologies that would be accepted by the ATO. These methodologies are equally important for a financial arrangement that was refinanced before the commence of the DDCR. For example, understanding in what circumstances the ATO would accept LIFO, FIFO or an averaging methodology. The inclusion of a statement that if the taxpayer is applying a FIFO, LIFO or averaging methodology consistently each income year to its financial arrangements and the methodology is aligned with legal arrangements, facts and circumstances it will be accepted by the ATO would be welcome.

We also submit that given that before the insertion of the DDCR, there was no need to trace, the ATO should consider including a practical solution in the draft PCG that deals with historic loans. This may include a de minimis test.

Some examples of the above commentary are set out below:

Example 1

It would be useful for the ATO to explain their views on the following approach:

1. A taxpayer has $300 of debt as at 30 June 2025 and has incurred $30 debt deductions in that year. The taxpayer has used their best endeavours to trace the use of funds and found that $100 of debt has been used for deductible purposes and $100 for non-deductible purposes. Thus $10 is initially denied being the debt deductions on $100 of debt for non-deductible purposes, and $10 of debt deductions is deductible.

2. This leaves $100 of debt the taxpayer cannot directly trace to a particular purpose despite their best endeavours. This $100 is then "pooled" and debt deductions on this amount are apportioned based on the allocating debt to DDCR impacted payments (say $50) and non-impacted payments ($50) based on statistical analysis derived from audited accounts and taxpayer records.

3. Thus $50 out of $100 (50%) of pooled debt is for non-deductible purposes, so a further 50% of $10 debt deductions ($5) is not deductible at stage 2.

4. The total debt deduction denial is thus $15.

Example 2

Similarly:

1. A profitable company generates $100 of profit in the year but does not have the cash as it's tied up in current receivables. It borrows short-term to fund a $100 dividend, which will be repaid once the receivables crystallise or via future profits. That company also seeks to invest $1,000 in a long-term capital project but requires $200 of long-term debt to fund the project. The company borrows $300, and the transactions go ahead.

2. Once the receivables are on hand, the company eventually repays $100, leaving the $200 behind to support the long-term capital project.

3. Such a scenario highlights that if apportionment is enforced due to a lack of 'contemporaneous documentation' then it does not make economic sense, because $100/$300 becomes 'DDCR debt' when the transaction happened.

4. This raises the question, does the repayment of that result in $67 continuing to be 'DDCR debt' for the entire duration of the long-term capital project?

Example 3 - Using FIFO to trace borrowings under a cash pool for dividends

<u>Facts</u>

Aus Sub Co is an Australian resident subsidiary of Head Co. Head Co is a foreign resident. Aus Sub Co has a cash pool facility with Fin Co (a foreign resident subsidiary of Head Co) where its net cash inflows and cash outflows are swept to on a daily basis (**Cash Pool Facility**). Cash inflows comprise receipts from sales to customers, and cash outflows comprise operating and capital expenditures. Aus Sub Co is a net borrower from Fin Co under the Cash Pool Facility due to funding of significant capital expenditure projects in Australia in the past. The interest rates applying to the Cash Pool Facility are benchmarked against arms' length rates. Interest accrues on a daily basis and is calculated by reference to the daily balance of the facility.

On 27 June 2024, Aus Sub Co paid a dividend of $500 to Head Co which was funded with a borrowing from Fin Co for the same amount through the Cash Pool Facility. As at 1 July 2024 (the start date for Subdivision 820-EAA), the balance of the Cash Pool Facility is in a net payable position with Aus Sub Co owing $700 to Fin Co.

Aus Sub Co's accounting records evidence the balance of the Cash Pool Facility before and after the 27 June 2024 dividend borrowing as follows:

Description	Date of transaction	Debits (net borrowings by Aus Sub Co)	Credits (net deposits by Aus Sub Co)	Running daily balance
Opening balance as at 27 June 2024		-	-	-$500

Net daily cash pool transaction (comprising **<u>$500 dividend</u>** borrowing only)	27 June 2024	-$500	-	-$1,000
Net daily cash pool transaction (net amount deposited from sales revenue and operating and capital expenses)	28 June 2024	-	$100	-$900
Net daily cash pool transaction (net amount deposited from sales revenue and operating and capital expenses)	29 June 2024		$100	-$800
Net daily cash pool transaction (net amount deposited from sales revenue and operating and capital expenses)	30 June 2024	-	$100	-$700
Aus Sub Co's accounting records evidence daily net deposit / borrowings with Fin Co on a daily basis including through to 1 July 2024. Aside from the 27 June 2024 dividend borrowing, all other amounts borrowed by Aus Sub Co related to the funding of operating and capital expenditures and did not relate to the acquisition of any assets from associates or the payment of any dividends, capital returns, royalties or similar payments to an associate.				
Opening balance as at 1 July 2024				-$7000

<u>Application of the DDCR</u>

Outcome

The DDCR disallows debt deductions for the interest Aus Sub Co incurs under the Cash Pool Facility on or after 1 July 2024 to the extent the balance of the Cash Pool Facility related to Aus Sub Co's use of the facility to fund the 27 June 2024 dividend of $500. As at 1 July 2024, $200 of the $700 closing balance related to the 27 June 2024 dividend applying a first in, first out (**FIFO**) tracing methodology.

Explanation

The requirements of section 820-423A(5) are satisfied in respect of the Cash Pool Facility and it is therefore necessary to determine the amount of deductions denied under section 820-423B(2). That subsection will deny debt deductions to the same extent to which Aus Sub Co used the Cash Pool Facility 'in a manner that satisfies paragraph 820-423A(5)(b)'.

Paragraph 820-423A(5)(b) is satisfied to the extent the balance of the Cash Pool Facility as at 1 July 2024 (being the time Subdivision 820-EAA started to apply) related to Aus Sub Co's 'use' of the Cash Pool Facility to fund the 27 June 2024 dividend.

Using a first in, first out (**FIFO**) methodology to trace the borrowing of the dividend and amounts repaid/deposited by Aus Sub Co under the Cash Pool Facility, the amount borrowed on 27 June 2024 was partly repaid as at 1 July 2024. However at least $200 of the Cash Pool Facility closing balance related to the 27 June 2024 dividend borrowing.

That is, applying a FIFO methodology, Aus Sub Co can show that of the $700 closing balance of the Cash Pool Facility as at 1 July 2024, only $200 related to the amount borrowed for the 27 June 2024 dividend.

Any interest incurred on or after 1 July 2024 is calculated by reference to the daily outstanding balance of the Cash Pool Facility. Only part of the outstanding balance of the Cash Pool Facility as at 1 July 2024 was referable to the amount borrowed to pay the 27 June 2024 dividend.

Example 4 - Tracing borrowing under cash pool for dividend and refinancing

<u>Facts</u>

Same facts as Example 3 above, except:

- On 30 June 2024, Aus Sub Co entered a refinancing transaction where Fin Co 2 (also a foreign resident subsidiary of Head Co) lent it $700 (Replacement Loan).
- Aus Sub Co uses the proceeds of the Replacement Loan to repay the Cash Pool Facility.
- Aus Sub Co enters into a new cash pooling arrangement with Fin Co.
- As at 1 July 2024, the Replacement Loan remains owing by Aus Sub Co to Fin Co 2.

Application of the DDCR

Outcome

The DDCR disallows debt deductions for the interest incurred under the Replacement Loan on or after 1 July 2024 to the same extent as under Example 11.

For completeness, the ATO will not commit compliance resources or interpret the DDCR provisions in a way that results in different outcomes depending on whether the rules apply to an 'original' debt interest or 'refinanced' debt interest.

Similarly, it is not open to interpret the rules in a way where a taxpayer with a debt interest which satisfies the requirements of sections 820-423A(2) or (5) can repay or refinance the affected debt interest with funds from a new debt interest and claim no denial of deduction under the new debt interest.

Explanation

The requirements of section 820-423A(5) are satisfied in relation to the Replacement Loan.

For the purposes of applying paragraph 820-423A(5)(b) and subparagraph 820-423A(5A)(f)(ii) to the Replacement Loan (and looking through to the Cash Pool Facility that was repaid), the repayment of the Cash Pool Facility (which was funded with the proceeds of the Replacement Loan) is referable to a debt interest that was a financial arrangement that satisfied paragraphs 820-423A(5)(a), (b) and (c), but only to the extent the Cash Pool Facility satisfied paragraph 820-423A(5)(b) at the time of it being repaid.

At the time the Cash Pool Facility was repaid, the Aus Sub Co accounting records demonstrate (using a FIFO tracing methodology) that $200 of the $700 closing balance of the Cash Pool Facility related to the borrowing by Aus Sub Co for the 27 June 2024 dividend paid to Head Co.

When applying section 820-423B(2) to the Replacement Loan, it is necessary to look through to the balance of the repaid debt interest at the time of repayment such that debt deductions on the Replacement Loan are denied to the same extent as the principal of the Replacement Loan relates to that part of the Cash Pool Facility ($200 out of $700) 'used' to fund the 27 June 2024 dividend (i.e. to the same extent the Cash Pool Facility was used 'in a manner that satisfies paragraph 820-423A(5)(b)').

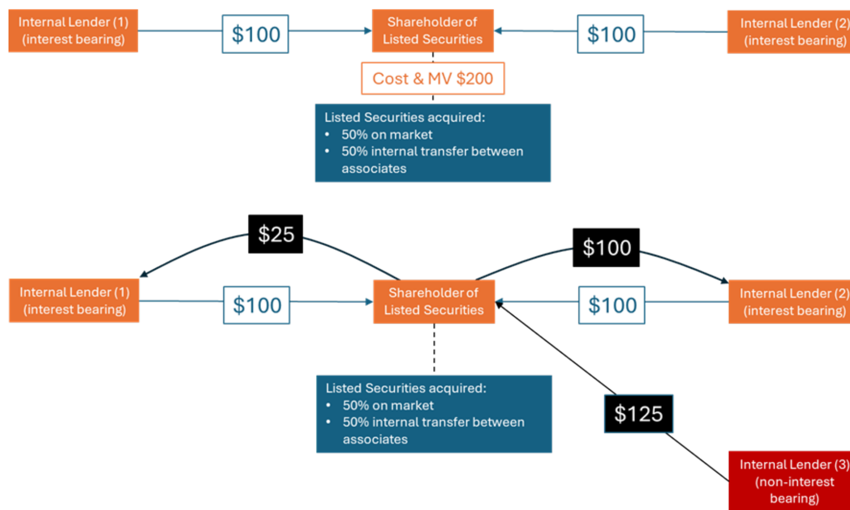
The outcomes in Examples 3 and 4 are consistent. That is, there is no difference in treatment between:

- a debt interest that funded a dividend (or other captured payment) that remains on foot at the commencement of Subdivision 820-EAA; and
- a debt interest that refinanced another debt interest that funded a dividend (or other captured payment), where the 'refinancing' debt interest remains on foot at the time commencement of Subdivision 820-EAA.

Example 5 – tracing of loans

In this example, a shareholder acquires 50% of listed securities on market with another 50% of listed securities transferred from an associate. To acquire the listed securities, the shareholder borrowed $100 from Internal Lender 1 and $100 from Internal Lender 2. Both loans are interest-bearing.

Subsequently, the shareholder then borrows $125 from Internal Lender 3 on non-interest-bearing terms. The proceeds of these funds were used to repay Internal Lender 2 in full and reduce the principal of Internal Lender 1 by $25.



We are seeking confirmation from the ATO that the following is correct:

- As long as the securities acquired via internal transfers is covered by the non-interest - bearing debt, the DDCR should not apply.

- The assumption is that all securities are funded with the same mix of interest-bearing debt (37.5%) and non-interest bearing debt (62.5%) so DDCR applies to only 50% of the interest-bearing debt.

- Direct tracing – when Internal Lender (1) provided finance to Shareholder, what parcels of securities were purchased (on market vs internal transfers)?