The Tax Institute

27 May 2026

The Hon David Bradbury
Chair
The Board of Taxation
Langton Crescent
Parkes ACT 2600

By email: taxboard@taxboard.gov.au

CC: Mr Paul Korganow, Secretary and Tax Counsel
The Board of Taxation
Paul.Korganow@treasury.gov.au

Dear Mr Bradbury,

Statutory review of Australia's thin capitalisation reforms

The Tax Institute welcomes the opportunity to provide a submission to the Board of Taxation's statutory review of Australia's thin capitalisation reforms (the **Review**).

In the development of this submission, we have closely consulted with our National Large Business and International Technical Committee to prepare a considered response that represents the views of the broader membership of The Tax Institute.

Australia's thin capitalisation regime was substantially amended by the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024* (Cth) (the **Amending Act**). The Explanatory Memorandum (**EM**) and the Supplementary Explanatory Memorandum (**Supplementary EM**) (together, **explanatory material**) explain the policy rationale of the Amending Act.

While we are supportive of the broad policy objective of aligning Australia's rules with international best practice, we are concerned that several of the provisions, as enacted, give rise to significant uncertainty and administrative complexity that are not justified from a policy perspective and are not consistent with broader initiatives to reduce red tape in the tax system. This submission identifies the key issues our members have encountered in applying the rules and sets out our recommendations for reform.

Level 21, 60 Margaret Street
Sydney NSW 2000
T 1300 829 338
E tti@taxinstitute.com.au
taxinstitute.com.au

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Many of these issues arise from unclear interactions among provisions, including the third-party debt test (**TPDT**), fixed ratio test (**FRT**), and debt deduction creation rules (**DDCR**), as well as inconsistent and insufficient Australian Taxation Office (**ATO**) guidance. This results in outcomes that, at times, appear inconsistent with the policy intent of the rules, particularly where overlapping provisions apply to the same arrangement. It also increases compliance complexity, as taxpayers and their advisers are required to interpret and reconcile multiple regimes without clear legislative or administrative guidance.

Summary of key concerns

Our key concerns with the current thin capitalisation rules are as follows:

- The choice requirements for the group ratio test (**GRT**), TPDT and FRT introduce unnecessary administrative complexity and inflexibility that is not justified on policy grounds.
- There is uncertainty about who may make a TPDT election, and the ATO has issued guidance that appear to be inconsistent with the legislation.
- The inadvertent removal of the exclusion for debt attributable to the overseas permanent establishments of outward-investing general class investors creates outcomes inconsistent with the policy intent of the rules.
- There is a 'black hole' in tax earnings before interest, taxes, depreciation, and amortisation (**EBITDA**) for investments in entities in which the taxpayer holds an interest between 10% and 50%, which has no policy basis.
- There are a number of technical limitations and uncertainties within the FRT, including the treatment of carried forward tax losses and the utilisation of disallowed amounts where an entity exits the regime.
- The GRT is difficult to apply in practice and may not be accessible to a range of taxpayers due to its complexity and structural limitations, raising concerns as to whether it is achieving its intended policy objective.
- The definition of 'associate entity' for the purposes of the TPDT has been broadened substantially beyond what the policy requires, creating significant practical difficulties.
- A number of key terms in the TPDT, including 'Australian asset', 'commercial activities in connection with Australia' and 'minor or insignificant', are undefined or subject to ATO interpretations that appear to be inconsistent with the statutory language and policy intent.
- The conduit financing rules are complex and difficult to apply in practice, particularly with respect to weighted-average pricing, foreign-exchange (**FX**) hedging costs, the passing on of swap costs, and residency requirements.
- The DDCR can be triggered inappropriately in circumstances involving conduit financing arrangements with an ultimate third-party lender.
- More broadly, the scope and operation of the DDCR extend beyond their intended policy objective, capturing commercial and, in some cases, wholly domestic arrangements, and give rise to disproportionate compliance and reporting obligations.
- The rules impose significant tracing and evidentiary burdens, particularly in relation to legacy arrangements and complex financing structures, increasing compliance costs and uncertainty.

Our detailed response and recommendations are contained in **Appendix A**.

Legislative clarity is fundamental to the integrity and effective operation of Australia's tax system. Taxpayers and their advisers must be able to understand and apply the law with confidence, without relying on administrative guidance that may be withdrawn or qualified over time or that is inconsistent with the statutory language. Where the legislation is ambiguous or yields outcomes inconsistent with policy intent, legislative amendment, rather than administrative practice, is the appropriate remedy.

The issues identified in this submission are not merely technical. They are areas of real uncertainty for businesses seeking to structure their financing arrangements and risk producing outcomes, including the denial of deductions for genuine third-party debt costs that are disproportionate and contrary to the policy objectives of the reforms. We are of the view that this Review presents an important opportunity to address these issues and to ensure that Australia's thin capitalisation rules operate as intended.

Feedback from our members indicates that these issues are already affecting financing decisions, increasing compliance costs, and creating uncertainty regarding the deductibility of genuine third-party debt. This may deter investment in Australia at a time where foreign investment is needed to support broader Government objectives.

We invite the Board of Taxation to contact our Tax Counsel, John Storey, on (02) 9603 2003 to arrange a meeting to discuss the issues outlined in this submission. We would be pleased to assist with proposed drafting to improve the operation of the rules.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

Yours faithfully,

Julie Abdalla
Head of Tax & Legal

Tim Sandow
President

APPENDIX A

We have set out below our detailed comments and observations for your consideration.

Overarching or threshold issues

Choice requirements

The current choice requirements for thin capitalisation introduce unnecessary administrative complexity and inflexibility, without a clear policy rationale. Unlike the prior regime, taxpayers are now required to make an election on an approved form under section 820-47 of the *Income Tax Assessment Act 1997* (Cth) (**ITAA 1997**) before lodging their tax return in order to apply either the GRT or the TPDT, with the FRT applying by default if no choice is made. This creates a rigid framework that limits taxpayers' ability to respond to uncertainty or evolving interpretations.

This approach is particularly problematic where there is uncertainty in applying the TPDT. If a taxpayer elects to apply the TPDT and it is later determined that the relevant debt does not satisfy the third-party debt conditions, the taxpayer is unable to fall back on the GRT or FRT without relying on the Commissioner's discretion. This creates the risk of inappropriate denial of deductions in circumstances where an alternative test would otherwise have applied.

Further, the Commissioner's discretion under subsection 820-47(6) of the ITAA 1997 is limited in scope and operation. It only allows a taxpayer to revoke a choice (resulting in the application of the FRT), rather than to switch between the GRT and TPDT, and it is subject to time limits that may not align with the practical realities of audits, objections, and extended amendment periods. This may leave taxpayers without recourse where issues are identified outside the relevant timeframe.

In addition, the timing requirements for making and revoking a choice are unnecessarily restrictive. A choice must be made by the earlier of the lodgement date and the due date for lodgement, which differs from the approach adopted for many other tax elections that allow choices to be made by the later of these dates. This misalignment can create compliance difficulties, particularly where taxpayers obtain lodgement deferrals but are still required to make elections based on the original due date.

In summary, the current framework imposes unnecessary rigidity and compliance risk, reduces flexibility for taxpayers, and may lead to outcomes that are inconsistent with the intended operation of the thin capitalisation regime.

Recommendation

The choice requirements in section 820-47 of the ITAA 1997 should be amended to provide greater flexibility and better reflect the policy intent of the thin capitalisation regime.

In particular:

- taxpayers should be permitted to change their chosen thin capitalisation method without requiring the exercise of the Commissioner's discretion;
- as a minimum, the Commissioner's discretion in subsection 820-47(6) should be expanded to allow taxpayers to switch between the GRT and TPDT, and should apply for so long as the relevant income year remains open for amendment; and

- the timing requirements for making and revoking a choice should be aligned with standard tax elections, such that the relevant deadline is the later of lodgement and the statutory due date.

Who can make a third-party debt test election?

There is uncertainty regarding whether a taxpayer who satisfies the requirements of section 820-37 of the ITAA 1997 (the 90% Australian assets test) is permitted to elect to apply the TPDT. While the legislation does not expressly prohibit such an election, current ATO website guidance and the approved form (NAT 75623) indicate that taxpayers who meet the requirements of section 820-37 of the ITAA 1997 cannot make a TPDT election. In particular, the approved form requires a declaration that the taxpayer does not satisfy section 820-37.

This creates ambiguity and inconsistency between the legislation and administrative practice. The inability to elect into the TPDT (or GRT) may lead to unintended and adverse outcomes. For example, taxpayers are required to choose a thin capitalisation method prior to lodging their tax return. If a taxpayer incorrectly assumes it satisfies section 820-37 and is therefore prevented from making an election, it may be unfairly disadvantaged.

Further, section 820-37 applies automatically rather than by choice, limiting flexibility for taxpayers to select the most appropriate method. This may produce unfair outcomes, particularly where a taxpayer meets the section 820-37 requirements but also holds only third-party debt that would otherwise satisfy the TPDT. In such cases, the taxpayer may be subject to the denial of deductions under the DDCR, even though those rules would not apply if a TPDT election were available.

The interaction between section 820-37, the TPDT election framework, and administrative guidance creates uncertainty and may result in outcomes that are inconsistent with the policy intent of the thin capitalisation regime.

Recommendation

We recommend that:

- the legislation should be amended to clarify that a taxpayer may make a TPDT (or GRT) election regardless of whether it satisfies the requirements of section 820-37 of the ITAA 1997; and
- the ATO's website guidance and approved form NAT 75623 should be updated to reflect the correct legal position, both pending and post legislative amendment.

Overseas permanent establishments and foreign hybrids

The current thin capitalisation rules give rise to unintended outcomes by denying deductions for debt attributable to the overseas permanent establishments of outward-investing general class investors. This represents a departure from the position that applied prior to the Amending Act and appears to be inconsistent with the broader policy framework.

Following the removal of the distinction between inward and outward investing entities for general class investors, the rules no longer disregard debt deductions attributable to overseas permanent establishments. As a result, such deductions may now be inappropriately denied, even though they relate to offshore activities.

This outcome appears inadvertent, as the explanatory material does not address the change, and the exclusion continues to apply to outward-investing financial entities under subsection 820-85(1) of the ITAA 1997. The inconsistency in treatment suggests a misalignment in the legislative design.

This issue also arises in the context of foreign hybrid limited partnerships. In practice, the denial of deductions means that the FRT becomes the only available thin capitalisation method, as such entities are unlikely to satisfy the TPDT due to its 'Australian' requirements. However, the FRT is also presenting challenges for these investment structures. For example, these entities may not have sufficient earning capacity to provide FRT capacity, or there may be a mismatch between the entity that is claiming debt deductions and the entity that recognises the gain on exit.

This contrasts with the treatment of controlled foreign companies, where thin capitalisation rules are disregarded entirely in calculating attributable income under subsection 389(c) of the *Income Tax Assessment Act 1936* (Cth).

The current rules produce outcomes that appear to be inadvertently inconsistent with the previous legislation and across comparable arrangements, lack apparent policy justification, and may unintentionally restrict the availability of debt deductions for offshore operations.

Recommendation

The legislation should be amended to reinstate the exclusion for outward investing general class investors, so that entities that are general class investors under subparagraph 820-46(b)(i) disregard debt deductions attributable to overseas permanent establishments when determining the amount of debt deductions to be denied. This would restore consistency with the previous legislation and across comparable arrangements, align the treatment across comparable entities, and ensure that offshore activities are not inappropriately subject to thin capitalisation limitations.

Debt deductions and amounts economically equivalent to interest

There is significant uncertainty regarding the scope of 'debt deductions' and, in particular, what constitutes an amount that is 'economically equivalent to interest' for the purposes of the thin capitalisation rules.

This uncertainty arises across a range of common financing arrangements, including:

- amounts treated as interest under Division 240 (hire purchase arrangements);
- the implicit interest component of finance leases and novated lease arrangements; and
- arrangements in which financing costs are embedded in broader contractual payments (for example, operating lease rentals or structured financing products).

The absence of clear legislative guidance creates a risk of inconsistent treatment between taxpayers, and increases compliance costs, as taxpayers must undertake complex economic analysis to determine whether amounts fall within scope. This issue has direct implications for the calculation of 'debt deductions' and 'net debt deductions' under all three thin capitalisation tests.

Recommendation

The legislation and EM should be amended to clarify the scope of 'debt deductions' and, in particular, give examples of the types of amounts that are 'economically equivalent to interest'.

Fixed ratio test – tax EBITDA 'black hole'

The current FRT rules create a gap in the treatment of investments where a taxpayer holds an interest of more than 10% but less than 50%. Under the existing framework, distributions from such investments are excluded from tax EBITDA (see subsections 820-52(3)–(9)), as the rules exclude distributions from entities in which the taxpayer holds an interest of 10% or more. At the same time, the taxpayer is not entitled to include a proportionate share of any excess tax EBITDA (see section 820-60) from the investee entity, as this uplift is only available where the ownership interest is 50% or greater.

This results in a 'black hole', where investors with interests in this range are unable to reflect either the distributions received or the underlying earnings of the investee entity in their tax EBITDA. The outcome appears inconsistent with the regime's policy intent and lacks a clear justification, particularly given that partial economic ownership exists, and the investor may be exposed to the investee's performance in a manner similar to higher-ownership stakes.

Recommendation

The FRT rules should be amended to eliminate the 'black hole' in tax EBITDA for interests of more than 10% but less than 50%. This should be achieved by allowing taxpayers to either:

- include distributions from such investments in tax EBITDA; or
- access a proportionate share of excess tax EBITDA at the investee entity level.

In addition, the ability to transfer excess tax EBITDA should be extended beyond trusts to companies and partnerships to ensure consistent treatment across entity types.

Additional issues with the fixed ratio test

In addition to the issues outlined above, other technical aspects of the FRT require clarification. There is uncertainty in relation to the treatment of carried forward tax losses under subsection 820-52(1A), including whether the adjustment should reflect the full balance of losses or only the amount that could be utilised in the relevant income year. Also, there is uncertainty regarding the treatment of FRT disallowed amounts in circumstances where an entity ceases to be subject to the thin capitalisation rules in a subsequent year (for example, due to a group restructure). While the EM to the Amending Act indicates that such amounts are not intended to be lost, there is no clear mechanism governing their utilisation.

Recommendation

The legislation should be amended to:

- clarify that adjustments for carried forward tax losses reflect only the amount capable of being utilised in the relevant year; and
- provide clear rules for the utilisation of FRT disallowed amounts where an entity is no longer subject to the thin capitalisation rules.

Group ratio test

Practical limitations of the group ratio test

While the GRT is intended to align interest deductions with the financing position of a taxpayer's worldwide group, it is, in practice, difficult for many taxpayers to apply. In particular:

- the complexity of the required adjustments limits the practical usability of the test; and
- certain groups are unable to apply the test due to the application of consolidation exemptions at the parent level (for example, where the worldwide parent entity is a pension fund or sovereign wealth fund).

These limitations raise questions as to whether the GRT is achieving its intended policy objective in practice.

Recommendation

The design of the GRT should be reviewed to:

- simplify the calculation requirements; and
- ensure that the test is accessible to a broader range of taxpayers.

As part of the Review, consideration should also be given to the extent to which the GRT is being utilised in practice.

Third-party debt test

Associate entity issues

The current 'associate entity' requirements within the TPDT (as modified by section 820-47D) create uncertainty and outcomes that appear broader than intended by the underlying policy. In particular, the modified definition in section 820-47D expands the concept of 'associate entity' beyond traditional associations, resulting in relationships being captured even where entities have only limited or indirect economic connections.

Under these rules, an associate entity relationship may arise between entities that are not otherwise associates, and the relevant ownership threshold is reduced to a 'TC control interest' of 20% or more. This represents a significant departure from the traditional 'associate interest' threshold of 50% and introduces an 'associate entity'-inclusive tracing approach. As a result, entities with only indirect and relatively minor interests may be treated as associate entities for example, where an ultimate investor holds a 20% interest in an intermediary that in turn holds 20% in the taxpayer, despite having no direct interest.

This broad approach does not appear aligned with the policy intent of the TPDT, which is to deny deductions for debt advanced by investors with a substantial economic interest in the taxpayer. Instead, the current rules may capture relationships involving limited and passive investments that do not raise integrity concerns.

The breadth of the definition also creates practical challenges. Taxpayers may not have sufficient visibility to identify all associate entities or determine whether such entities hold their debt, particularly given the increasing prevalence of private capital and fund-based investment structures. In addition, for certain types of widely or publicly traded debt instruments, such as US notes or other transferable securities, it may not be feasible to identify holders on an ongoing basis.

Further, the rules may produce unintended outcomes in which otherwise independent third-party debt is treated as associate-entity debt. For example, where a taxpayer is owned by a consortium that includes a State-owned entity, it is possible that State-owned banks from the same jurisdiction could participate in a lending syndicate. Despite acting independently and on arm's length terms, those lenders may be treated as associate entities, resulting in third-party debt being excluded from the TPDT.

Overall, the current 'associate entity' rules are overly broad, create uncertainty and compliance challenges, and risk denying access to the TPDT in circumstances that do not align with its intended policy objective.

Recommendation

The definition of 'associate entity' in section 820-47D should be refined to better align with the policy intent of the TPDT, including by:

- increasing the relevant ownership threshold for determining an associate entity relationship; and
- excluding entities with only minor or indirect economic interests that do not give rise to influence or control over the borrower.

Consideration should also be given to introducing specific exclusions for widely held or publicly traded debt arrangements, including debt issued under section 128F, where it is impractical to identify holders and where the risk of non-arm's length outcomes is low.

Undefined terms

Australian asset

The absence of a clear definition of 'Australian asset' creates significant uncertainty in applying the TPDT, particularly in relation to intangible assets and membership interests. Given that one of the third-party debt conditions in paragraph 820-427A(3)(c) requires lenders to have recourse only to Australian assets (other than those that are minor or insignificant), the lack of clarity around this core concept makes it difficult for taxpayers to apply the rules with confidence in practical, real-world scenarios.

While the characterisation of tangible assets is generally straightforward, there is substantial ambiguity in determining whether intangible assets are Australian or non-Australian. This is particularly evident in membership interests, where it is unclear whether their location should be determined by reference to the place of registration, the entity's location, the location of the underlying assets, or another criterion.

This uncertainty is compounded by inconsistent signals in ATO Taxation Ruling TR 2025/2: *Income tax: aspects of the third party debt test in Subdivision 820-EAB of the Income Tax Assessment Act 1997* (**TR 2025/2**). Paragraph 96 of TR 2025/2 suggests that, in the context of membership interests, a 'look-through' approach should be applied by reference to the assets of the underlying entity. However, paragraph 42 indicates that rights and membership interest themselves are the relevant assets, and that there is no requirement to look through to underlying assets when determining the assets to which a lender has recourse.

The practical effect of this interpretation is that corporate groups with any material non-Australian assets may be unable to satisfy the TPDT, even where those assets are held by entities outside the obligor group and are not subject to lender recourse. In these circumstances, membership interests in such entities may be treated as non-Australian assets, potentially disqualifying otherwise compliant financing arrangements.

In summary, the absence of a clear and consistent definition of 'Australian asset' introduces significant uncertainty, may lead to unintended outcomes, and risks limiting access to the TPDT in circumstances that do not align with the underlying policy intent.

Recommendation

- The concept of 'Australian asset' should be defined in the legislation, with clear rules for the treatment of intangible assets and membership interests.
- In particular, the legislation should clarify whether the characterisation of membership interests as Australian or non-Australian requires a look-through to underlying assets or is determined by reference to where the interests are located or the entity is established.

Commercial activities in connection with Australia

The meaning of 'commercial activities in connection with Australia' in the TPDT in paragraph 820-427A(3)(d) creates significant uncertainty, particularly regarding whether debt used to fund distributions to investors satisfies this requirement. The ATO's interpretation, including the view expressed in paragraph 125 of TR 2025/2, suggests that funding investor distributions is not part of an entity's commercial activities. This approach departs from the established purpose of the concept, which historically served to distinguish Australian from non-Australian activities rather than to exclude particular types of domestic transactions.

This interpretation is difficult to reconcile with the statutory framework, policy intent, and judicial authority. In particular, it is inconsistent with the refinancing principle in *Federal Commissioner of Taxation v Joan Dorothy Roberts; Commissioner of Taxation v Valentine Roy Smith* (1992) 37 FCR 246, which is also reflected in ATO guidance in Taxation Ruling TR 2005/12: *Income tax: deductibility of interest expenses incurred by trustees on funds borrowed in connection with the payment of distributions to beneficiaries*). The refinancing principle supports the deductibility of interest where borrowings replace equity previously used in income-producing activities.

The ATO's interpretation of the meaning of 'commercial activities in connection with Australia' is also inconsistent with judicial guidance that 'commercial' is to be distinguished from private or domestic activity, as noted by Gordon J in *Visy Industries USA Pty Ltd v* FCT [2011] FCA 1065 at [80].

Further, the ATO's position appears to disregard the legislative history and broader framework, including the deliberate design of the DDCR, and risks denying deductions for common commercial arrangements such as regearing transactions. Overall, the current drafting creates uncertainty and potentially inappropriate outcomes, particularly because the TPDT applies to existing debt arrangements.

Recommendation

The legislation should be amended to clarify that debt used to fund distributions to investors can satisfy the 'commercial activities in connection with Australia' requirement where the related financing costs otherwise meet the nexus requirements under sections 8-1 or 230-15 of the ITAA 1997. This clarification would align the TPDT with established tax principles, judicial authority, and policy intent, and ensure that ordinary commercial financing arrangements, including equity refinancings, are not inappropriately denied deductibility.

Minor or insignificant

The concept of 'minor or insignificant' in the TPDT in paragraph 820-427A(3)(c) creates uncertainty and interpretive difficulties, particularly due to the ATO's view that it refers to assets of 'minimal or nominal value'. This interpretation appears inconsistent with both the statutory language and the policy intent outlined in the Supplementary EM, which indicates the carve-out is intended to prevent inadvertent or superficial breaches.

The terms 'minor' and 'insignificant' are inherently relative and contextual, yet there is no clear guidance on how to apply them. It is also unclear whether the terms operate conjunctively or disjunctively, and whether the assessment should take into account the size and nature of the taxpayer's operations. The current interpretation risks applying an overly narrow, absolute threshold, which may exclude assets that are not material to a lender's credit assessment.

This creates practical uncertainty and outcomes that do not align with commercial reality, as assets that would not influence an independent lender's decision may nevertheless prevent access to the TPDT.

Recommendation

The legislation should be amended to clarify the meaning of 'minor or insignificant' in paragraph 820-427A(3)(c) to ensure it operates as a relative, principles-based concept.

In particular:

- the test should be framed by reference to the perspective of an independent lender and the materiality of assets to a credit assessment;
- it should be clarified that an asset may be either minor or insignificant (and does not need to satisfy both limbs); and
- while consideration may be given to introducing a safe harbour threshold, this should supplement (and not replace) the broader relative assessment.

Credit support rights

The operation of the TPDT in relation to 'credit support rights' (including subsection 820-427A(5)) gives rise to significant uncertainty and may lead to unintended outcomes. In particular, the current provisions do not clearly distinguish between credit support that enhances the borrower's credit (which is appropriately within scope) and arrangements that support obligations owed to the taxpayer under ordinary commercial dealings. As a result, there is a risk that standard arm's length arrangements, such as leases or offtake agreements, may be inappropriately treated as disqualifying credit support.

Under the current rules, a debt interest will fail the third-party debt conditions where the lender has recourse to 'a right under or in relation to a guarantee, security or other form of credit support', unless a specific carve-out applies. While the policy intent outlined in paragraph 2.99 of the EM is to ensure that third-party debt is supported by the assets of the borrower (and other obligors), rather than by associate entities, the drafting is broad and creates uncertainty about its application to commercial arrangements involving associates.

The ATO's interpretation, including in Example 6 in TR 2025/2, highlights this issue. In that example, a lease between Asset Trust and Sub Co is not itself treated as credit support. However, a guarantee provided by Head Co in support of Sub Co's lease obligations is treated as a credit support right requiring consideration under subsection 820-427A(5). This outcome suggests that arrangements that support obligations owed to the taxpayer (rather than obligations owed by the taxpayer to the lender) may still be regarded as problematic, even though they do not enhance the borrower's credit.

This approach creates anomalous results. For example, leasing property directly to Head Co would produce a different outcome than leasing to Sub Co with a guarantee from Head Co, even though the commercial and economic substance is equivalent. Similarly, in sectors such as renewables, offtake agreements with project sponsors, which are often essential for financing, may be seen as enhancing credit and therefore potentially implicated, even though they are standard arm's-length commercial arrangements.

There is also broader uncertainty regarding the application of the rules to different types of credit support, particularly in light of the approach in TR 2025/2. This includes questions about the treatment of performance guarantees versus financial guarantees, whether guarantees provided directly to lenders affect the analysis differently, and how bank guarantees should be treated, especially when supported by collateral from a foreign parent.

Taken together, the current drafting and interpretation create uncertainty, risk unintended denial of access to the TPDT, and may discourage ordinary commercial arrangements involving associated entities that are not contrary to the underlying policy intent.

Recommendation

Subsection 820-427A(5) should be amended to clarify that it:

- applies only to credit support arrangements that support the borrower's obligations to the lender; and
- does not extend to ordinary commercial arrangements that support obligations owed to the taxpayer.

The legislation should also expressly confirm that third-party bank guarantees (including those facilitated by foreign parents) can satisfy the third-party debt conditions.

Conduit financing rules

The conduit financing rules in sections 820-427B and 820-427C are intended to ensure that the TPDT operates appropriately in circumstances where debt that satisfies the third-party debt conditions is on-lent within a group of associate entities on substantially the same terms. As summarised in the EM at paragraph 2.105:

> Additional rules allow for conduit financer arrangements to satisfy the third party debt conditions in certain circumstances. Such arrangements are generally implemented to allow one entity in a group to raise funds on behalf of other entities in the group. This can streamline and simplify borrowing processes for the group.

While the intention of the rules is clear, their drafting is complicated, and the ATO's interpretation of the provisions makes them difficult and, in some cases, impractical to apply in practice. This creates uncertainty for taxpayers and may prevent the conduit financing rules from operating as intended in common commercial arrangements.

Key issues and recommended reforms in relation to the conduit financing rules are set out under the sub-headings below.

Weighted average pricing

The requirement that the terms of an on-loan (as required under paragraph 820-427C(1)(d)) in relation to cost be 'substantially the same' as the terms of the ultimate debt interest creates practical complexity and uncertainty in applying the conduit financing rules. In ATO Practical Compliance Guideline PCG 2025/2: *Restructure and the thin capitalisation and debt deduction creation rules – ATO compliance approach* (**PCG 2025/2**) (including Example 36), this condition has been interpreted by the ATO as requiring separate, individually priced on-loans for each source of external debt held by a financing entity.

This interpretation is administratively burdensome and does not align with how financing arrangements typically operate in practice, particularly where a financing entity raises funds from multiple sources and on-lends them within a group. It also introduces unnecessary complexity in complying with the TPDT and conduit financing requirements.

Further, the current approach may give rise to unintended behavioural changes, as it allows for selective allocation of higher- or lower-cost debt across different entities within a group. This creates opportunities for arbitrage based on tax positions rather than reflecting genuine commercial funding arrangements.

Overall, the strict 'substantially the same terms' requirement, as currently interpreted, imposes unnecessary compliance burdens and may lead to outcomes that are inconsistent with commercial practice and the underlying policy intent of the conduit financing rules.

Recommendation

The conduit financing rules should be amended to permit on-lending at an interest rate equal to the weighted average cost of external debt (adjusted for hedging), rather than requiring strict alignment on an instrument-by-instrument basis.

FX hedging

The current rules do not clearly address the treatment of FX hedging costs under the thin capitalisation and conduit financing provisions. This creates uncertainty as to whether such costs are treated as debt deductions and, if so, whether they can be on-charged within a group. In practice, this limits conduit financiers' ability to recover legitimate FX hedging costs, particularly when these costs arise from cross-currency interest rate swaps.

Recommendation

The legislation should clarify that FX hedging costs are either not debt deductions or, where they are, may be passed through under conduit financing arrangements (consistent with interest rate swap costs) without affecting deductibility.

Passing on swap costs

The conduit financing rules were intended to allow a conduit financier to pass on the costs and benefits of interest rate swaps and hedging (as reflected in paragraph 1.26 of the Supplementary EM). However, the ATO's interpretation, as evidenced in Example 1 in TR 2025/2 and Example 37 in PCG 2025/2, creates uncertainty and inconsistent tax outcomes depending on how those costs are passed on. In particular, the ATO's view suggests that swap costs are not deductible when passed on under a standalone on-swap agreement, are deductible when embedded in the interest rate of an on-loan, and remain unclear when charged separately under combined on-loan/on-swap arrangements. This form-driven approach is impractical, departs from the intended policy, and may require unnecessary restructures (as noted in the compliance approach in Example 37), with no clear basis for differing tax outcomes.

Recommendation

The legislation should be amended to ensure consistent tax treatment of swap and hedging costs regardless of how they are passed through. In particular, it should allow the on-charge of such costs (without markup) under conduit financing arrangements, irrespective of form, including through a deeming rule where appropriate, to ensure deductibility aligns with policy intent, and to reduce unnecessary complexity and restructuring.

Residency requirement

The current conduit financing rules require that all entities involved in a conduit financing arrangement be Australian entities. This requirement creates a significant limitation in practice, as it effectively prevents groups with centralised or foreign-based treasury functions from accessing conduit financing under these rules.

This outcome appears inconsistent with the regime's underlying policy intent. The conduit financing rules already include safeguards to ensure integrity, including the requirement that there is no mark-up on the cost of external debt and that the TPDT limitations regarding recourse to Australian assets continue to apply. Despite these protections, the blanket requirement that all entities in the structure be Australian restricts legitimate commercial arrangements without clear policy justification.

The requirement introduces unnecessary constraints and may exclude common financing structures that do not raise integrity concerns, limiting the practical application of the conduit financing rules.

Recommendation

The requirement that all entities involved in a conduit financing arrangement be Australian residents should be removed or relaxed to accommodate common treasury structures.

Duplication

The conduit financing rules (including sections 820-427A to 820-427C) can result in inappropriate duplication of denied deductions where debt does not satisfy the third-party debt conditions, leading to outcomes that exceed the intended policy effect. Rather than ensuring that only related-party debt is penalised, the current interaction between the TPDT and conduit financing rules can result in the same amount being effectively denied more than once, creating an excessive economic burden.

For example, where a financing entity (**FinCo**) incurs $1,000 of debt costs under a syndicated facility, with 10% funded by an associate entity and the remaining 90% by third parties, and on-lends the full amount on back-to-back terms to a Project Trust, the intended outcome would be to deny deductions only for the $100 attributable to the related-party funding. However, under the current rules, this amount is effectively denied twice, once at the FinCo level (as the related-party portion does not satisfy the third-party debt conditions) and again at the Project Trust level (as the corresponding portion of the on-loan fails the conduit financing requirements). This results in a total denial of $200 of deductions, rather than the intended $100.

The issue can be exacerbated in structures involving multiple layers of on-lending, where the same economic cost may be denied repeatedly as it passes through the group.

The current design of the conduit financing rules risks duplicating the denial of deductions, producing outcomes that are disproportionate to the policy intent of limiting deductions for related-party debt.

Recommendation

The legislation should be amended to ensure that, where conduit financing rules apply, denial of deductions occurs only once, at the level of the ultimate borrower.

Debt deduction creation rules

Overarching concerns with the design and administration of the debt deduction creation rules

We note that the DDCR were introduced without prior exposure draft consultation. This was a missed opportunity to engage with stakeholders on issues in the legislation that could have been avoided and should be treated as a learning experience for Government.

While the DDCR are intended to target arrangements involving related-party debt that do not give rise to genuine economic costs, as enacted, the rules operate significantly broader than the policy intent. In particular:

- the drafting captures arrangements beyond those involving artificial or non-commercial outcomes; and
- the ATO has issued administrative guidance but limited detailed technical analysis addressing key interpretive issues.

These factors have resulted in significant uncertainty regarding the operation of the DDCR.

In addition, the scope of the DDCR gives rise to outcomes that appear inconsistent with the underlying policy intent. In particular:

- the rules may apply to wholly domestic arrangements, including private groups and Division 7A compliant loans;
- there is no exemption for entities that satisfy section 820-37 of the ITAA 1997; and
- the rules impose significant additional disclosure obligations, including in the International Dealings Schedule, even where no denial of deductions arises.

Recommendation

The DDCR should be revisited to:

- better align its operation with the policy intent of targeting artificial or non-commercial related-party debt arrangements, supported by constructive stakeholder consultation and clearer legislative guidance;
- exclude purely domestic arrangements and entities that satisfy section 820-37 of the ITAA 1997, and
- ensure that compliance obligations are proportionate to the risks addressed.

Inappropriate application of the debt deduction creation rules to conduit financing arrangements

The current operation of the DDCR (Subdivision 820-EAA, including section 820-423A) may inappropriately apply to conduit financing arrangements, resulting in the denial of deductions in circumstances that do not align with the policy intent of targeting related-party debt. While the DDCR was amended during the legislative process to limit its application to deductions referable to payments to an associate pair, it does not incorporate a concept equivalent to the conduit financing rules in the TPDT.

As noted in paragraph 1.42 of the Supplementary EM, the purpose of the related party debt deduction condition is to ensure that the rules target arrangements where there is little or no real economic cost to the group. However, in the absence of a conduit financing concept, the DDCR may apply even where debt is effectively raised from unrelated third parties and on-lent within a group on back-to-back terms.

This creates practical issues for a range of common commercial structures, including non-consolidated groups of trusts, corporate groups that have not elected to consolidate, and groups with centralised treasury functions (particularly where the treasury entity is offshore). In these structures, intra-group on-lending arrangements are commonly used where the underlying debt is raised from third-parties.

As a result, the DDCR may be triggered inappropriately for groups that do not engage in the kind of related-party financing arrangements the rules are intended to address. Although taxpayers may seek to rely on the TPDT to preclude the application of the DDCR, this is not always a practical solution. Demonstrating compliance with the TPDT may be more complex than applying the FRT, certain taxpayers may not be able to access the TPDT, and once an election is made, it may not be possible to revert to another method if the TPDT requirements are not satisfied.

Overall, the absence of a conduit financing concept within the DDCR creates a risk that the rules apply too broadly, capturing arrangements involving genuine third-party debt, and producing outcomes that are inconsistent with the stated policy intent.

Recommendation

The DDCR should be amended to include a conduit financing concept equivalent to that contained in the TPDT, so that the DDCR does not apply to payments made under a conduit financing arrangement where the ultimate lender is not an associate entity. This amendment would ensure the DDCR is properly targeted at genuine related party debt, consistent with the policy intent stated in the Supplementary EM.

Tracing requirements and compliance burden

The DDCR impose significant compliance burdens due to the requirement to trace the use of funds through multiple layers of transactions and, in some cases, over extended historical periods. Key concerns include:

- the need to trace the historical use of funds for existing debt arrangements in the absence of grandfathering provisions;
- practical difficulties in obtaining contemporaneous documentation for legacy arrangements; and
- the disproportionate compliance burden relative to the integrity risks targeted.

In practice, these requirements may result in deductions being denied due to evidentiary limitations rather than inappropriate structuring.

Our members have also highlighted the increasing reliance on global market intelligence databases to comply with the DDCR and TPDT requirements. In particular, identifying associate entities, determining whether such entities hold debt interests, and tracing the flow of funds through complex financing arrangements, present significant practical challenges. In many cases, taxpayers are required to use global market intelligence databases to obtain this information, resulting in additional compliance costs.

Benchmarking the interest rate on related-party debt against comparable market transactions is a standard requirement. However, additional obligations arise under the Arm's Length Debt Test, which requires demonstrating that an independent commercial lender would have provided the same level of debt. This involves identifying comparable loans, analysing financial ratios of similar entities, and assessing factors such as interest rates and debt quantum. In practice, these processes often require the use of market intelligence databases, resulting in increased compliance costs.

This sits alongside existing compliance requirements, including the need to determine a pricing risk score under ATO Practical Compliance Guideline PCG 2017/4: *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions* (**PCG 2017/4**). For example, paragraph 56 of PCG 2017/4 requires benchmarking against traceable third-party debt, relevant third-party debt of the group, and the global group cost of funds.

These cumulative requirements materially increase the compliance burden for taxpayers, particularly for groups with complex or widely held debt structures.

Recommendation

The DDCR should be amended to reduce compliance burdens by:

- introducing grandfathering for pre-existing debt;
- providing safe harbours or simplified tracing methods;
- ensuring deductions are not denied solely due to inability to evidence historical fund flows; and
- reduce reliance on external data sources, including global market intelligence databases, where such reliance is disproportionate to the risks being addressed.