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Mr Vy Tran
Assistant Commissioner
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Australian Taxation Office

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18 July 2025

Dear Vy,

Draft Practical Compliance Guideline PCG 2025/D2 - Factors to consider when determining the amount of your inbound, cross-border related party financing arrangement - ATO compliance approach

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 175,000 members in over 100 countries and regions. We make this submission in response to The Australian Taxation Office (ATO)'s draft **PCG 2025/D2 - Factors to consider when determining the amount of your inbound, cross-border related party financing arrangement - ATO compliance approach** (PCG) released on 29 May 2025 on behalf of our members.

We appreciate the opportunity to provide comments on PCG 2025/D2, which outlines the Commissioner's compliance approach to assessing the tax risk associated with the *amount* of debt under inbound cross-border related party financing arrangements, pursuant to Subdivision 815-B of the ITAA 1997.

While we support the ATO's efforts to provide greater transparency and structure to its compliance framework, we have a number of concerns regarding the draft PCG's practical application. In particular:

- The guidance is overly theoretical and lacks sufficient clarity or practical examples to assist taxpayers in self-assessing their risk, especially for small and medium-sized businesses;
- The examples provided are limited in scope and may result in the majority of taxpayers defaulting to blue zone classifications, potentially attracting unnecessary compliance attention;
- The current risk zone framework is unclear, including the interaction between "white" and "green" zones following ATO reviews;
- No meaningful compliance concessions are offered for low-value or low-risk arrangements;
- The PCG's approach to debt testing on an annual basis does not align with the commercial reality of multi-year debt arrangements;
- The guidance does not adequately consider discretionary trusts, which are common vehicles for inbound investment and face different financing constraints from corporate entities.

We have included detailed suggestions in our submission to improve the clarity, proportionality and commercial realism of the PCG. These include proposals for a de minimis threshold, a more metric-driven and industry-aligned risk framework, and expanded examples to better reflect practical funding scenarios.

We would welcome the opportunity to discuss our submission further and assist the ATO in refining this guidance.

Please refer to the Appendix for our detailed discussions. If you have any queries, contact me at jenny.wong@cpaaustralia.com.au or Bill Leung, Tax Technical Advisor at bill.leung@cpaaustralia.com.au.

Yours sincerely,

Jenny Wong
Tax Policy Lead

Appendix

Detailed discussion

General comments

We welcome the ATO's efforts to provide guidance through Draft PCG 2025/D2 on its compliance approach to assessing the tax risk associated with the amount of inbound, cross-border related party financing arrangements under Subdivision 815-B of the ITAA 1997. However, we are concerned that the draft PCG is overly theoretical and lacks practical guidance that taxpayers can readily apply.

In particular, the PCG appears to require an extensive documentation exercise, yet provides limited clarity on how to assess whether the documented arrangement is considered high or low risk. The focus on qualitative factors to be documented seems misaligned with the illustrative examples, which are predominantly based on numerical outcomes. This is unsurprising, given the PCG's focus on the amount of debt. However, we would expect that even in high-risk scenarios, a taxpayer should be able to demonstrate the appropriateness of their debt level when assessed against the nine factors in the PCG. This stands in contrast **PCG 2017/4**, where the risk assessment process is largely a straightforward, quantitative exercise based on pricing.

Furthermore, the draft PCG does not appear to offer any compliance-saving measures. This may inadvertently increase the compliance burden, particularly if ATO officers use the guideline to request extensive documentation from taxpayers.

Finally, the treatment of internal funding and capital raising options appears overly simplistic and not reflective of commercial realities. The suggestion that internal funds, debt, and equity are equally available options does not align with the practical experience of many businesses. For example, a company experiencing a working capital shortfall is unlikely to have internal funds available, and debt is often a more viable and efficient source of funding than equity—even within wholly owned groups where shareholder dilution is not a concern.

Comments on examples and risk assessment zones

We are concerned that the examples provided in the draft PCG are too limited and do not offer sufficient clarity or practical utility for taxpayers. As drafted, most taxpayers would find it difficult to self-assess as being in the green zone. If such a self-assessment is required to be reported in the Reportable Tax Position (RTP) schedule, we expect that the majority of taxpayers would fall into the blue zone, which may unfairly subject them to additional scrutiny despite having reasonable arrangements in place.

Example 1 is particularly narrow in scope. Most taxpayers are unlikely to rely on the third-party debt test, and where interest deductions on related party loans are already fully denied, there is no residual risk under Division 815. In addition, smaller taxpayers who fall below the Division 820 threshold (i.e. the $2 million de minimis threshold) may not be eligible to apply the third-party debt test at all, but are still subject to the transfer pricing rules. This creates uncertainty and unnecessary compliance burdens for those entities.

Example 2 requires taxpayers to undertake a benchmarking exercise to determine leverage and interest coverage ratios based on a set of comparable entities. This imposes a significant compliance burden, particularly for small and medium-sized businesses with relatively modest related party funding. Further, the ATO is likely to review the comparables selected, thereby diminishing the usefulness of the example as a low-risk scenario or as a means of achieving any meaningful compliance savings.

We recommend that the PCG adopt an "OR" test rather than an "AND" test — i.e. taxpayers should be able to benchmark against either the global group or a set of comparable entities, not both. This would streamline compliance while still enabling the ATO to assess risk effectively.

Suggested improvements to the examples:

- Example 2: While currently characterised as low risk, the example would be more instructive if it included variations in outcomes — for instance, scenarios where a taxpayer's ratios are below those of the global group but better than the comparables, or vice versa.

- Example 4: Clarify that the guarantee provided is separately priced and benchmarked, which would reflect commercial practice more accurately.

- Example 5: This example appears to address a potential tax avoidance arrangement rather than the appropriate quantum of debt. It may be better placed in a different guidance product and feels somewhat misaligned with the PCG's stated focus.

- Additional suggestions: The PCG could incorporate some form of risk classification based on standard serviceability and leverage ratios (e.g. 60/40 debt-to-equity), in line with PCG 2017/4. This would provide a more practical and quantitative framework for risk assessment, assisting taxpayers in navigating their obligations with greater confidence.

Ultimately, we believe that without more detailed and commercially realistic examples, the PCG risks becoming a statement of the ATO's views on documentation expectations, rather than a meaningful compliance guidance.

De minimis rule

The draft PCG offers limited support for small and medium-sized businesses. We strongly recommend that the ATO incorporate a de minimis threshold or a tiered risk assessment approach for smaller inbound loans. It is not reasonable for the documentation expectations relating to the quantum of debt to be the same for a $500,000 loan as for a $500 million loan.

We suggest the following options to improve proportionality:

- Adopt an approach similar to **PCG 2021/5**, which includes a green zone for imported hybrid mismatches where total cross-border deductible payments are less than $2 million in an income year. A comparable threshold could be introduced for debt deductions under inbound cross-border loans. We note that in Example 5 of the draft PCG, over $30 million in debt deductions are required for the arrangement to fall into the red zone — suggesting scope for a materiality threshold.

- Align with **PCG 2017/2**, which provides simplified transfer pricing record-keeping options for low-level inbound loans. A consistent risk approach could apply for the quantum of debt, such as treating inbound loans under AUD 50 million as lower risk. Alternatively, PCG 2017/2 could be updated to cover the amount of debt, incorporating commonly accepted financial metrics — such as debt-to-equity or debt-to-assets ratios, potentially tailored by industry, and/or interest coverage ratios as indicators of serviceability.

Introducing a de minimis threshold or simplified framework would promote a more balanced and efficient compliance approach, especially for smaller entities with limited resources, while still supporting the ATO's objective of ensuring appropriate tax outcomes for related-party financing.

Risk rating approach

The current risk zone framework in the draft PCG is unhelpful in its current form, as it is based on only five overly simplistic examples. For instance, it is unclear why an arrangement where no debt deductions are claimed would even need to be classified as low risk — this seems self-evident and of limited practical value.

We also find the interaction between paragraphs 30 and 32 confusing. Paragraph 30 states that a low-risk rating resulting from an ATO review completed after 1 January 2025 is classified as white zone, while paragraph 32 refers to a low-risk rating on review as green zone. We assume the distinction is based on the timing of the review, but this is not clearly explained.

To illustrate the uncertainty: if an arrangement is initially self-assessed as blue zone in year 1 and subsequently reviewed and rated as low risk, does it move to green zone in year 2 and then to white zone in year 3? How would

this process change if the ATO review results in a new low-risk example being added to the PCG? Greater clarity on these transitions and their implications is needed.

We submit that a metric-driven risk-rating framework may be more effective at guiding taxpayer behaviour and streamlining compliance, such as:

- Debt-to-equity ratio bands, e.g.:
    - Less than 60% = green zone
    - 60–80% = amber zone
    - Greater than 80% = red zone

  Note. The percentages above are just an example and the ATO should adopt an appropriate green zone metric.

- These metrics could be industry-adjusted, consistent with the approach in PCG 2019/1 for inbound distributors. For example, capital-intensive sectors such as property or infrastructure would reasonably be expected to sustain higher levels of secured debt than other sectors.

- This approach would not need to operate as a formal safe harbour, but rather as a practical indicator of relative risk — allowing taxpayers to assess whether their arrangements are likely to attract ATO compliance attention.

Adopting a clearer, metric-based framework - supplemented by better-quality and more realistic examples - would enhance the usefulness of the PCG and better support taxpayers in self-assessing their risk.

Discretionary trusts

The draft PCG has a focus on the financing of corporate entities and does not consider discretionary trusts. Many of the factors in the ruling are not relevant to discretionary trusts who cannot issue equity and obtain funding in the same way as companies and unit trusts can. The PCG should address the unique circumstances that apply to discretionary trusts.

Debt alignment

The PCG applies on an income year-by-income year basis, which may not align with the nature of a debt arrangement. A third party lender will (usually) consider the financial position of the borrower in the initial year of providing a loan. Unless the loan agreement includes financial covenants, changes to the financial position of the borrower in subsequent years will not necessarily mean that the lender can or will reduce the size of the loan amount. In contrast, the PCG requires a taxpayer to test the arm’s length nature of a loan in each income year, rather than just at the time of entering the loan.