Tax News & Insights

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ATO compliance approach on thin capitalisation and DDCR

On 20 August 2025, the ATO released its (near) finalised *Practical Compliance Guideline* PCG 2025/2 (previously PCG 2024/D3) which outlines its compliance approach and risk assessment framework in respect of restructures entered into on or after 22 June 2023 in response to the new thin capitalisation rules and debt deduction creation rules ("DDCR"). The PCG is in near finalised form because Schedule 3 noted below remains in draft form.

The main body of PCG 2025/2 sets out the general principles of the ATO's risk approach and the guideline also contains the following schedules:

- Schedule 1 – examples where the DDCR may need to be considered
- Schedule 2 – risks arising from restructures in response to the DDCR
- Schedule 3 – targeted compliance areas for the third party debt test (remains in draft form and expected to be finalised at the same time as draft Taxation Ruling TR 2024/D3)
- Schedule 4 – risks arising from restructures in response to the thin capitalisation rules

The updated PCG 2025/2 is largely the same as the draft. A few additional examples have been included for clarity, though there is no material change to the stance of the ATO on the application of the DDCR. Most of the examples in the PCG are straightforward, and there continues to remain various scenarios that are not covered by the examples in PCG 2025/2. Some key points to note include:

- The DDCR requires taxpayers to trace the use of relevant debt funding on both a direct and indirect basis. The ATO notes that tracing is a factual exercise but does not provide any methodology or practical guidance on the same. Apportionment methodologies may be used where tracing is not possible.
- Despite the challenge of obtaining evidence to substantiate the historical use of associate funds, the onus remains on the taxpayer to prove that DDCR does not apply (i.e., there is no grandfathering or temporal concession). A deduction should not be claimed unless sufficient information is available to conclude that DDCR is not applicable.
- Taxpayers should maintain contemporaneous documentation on associate funding cash flows.
- There is no 'de minimis' threshold for the maintenance of documentation to support a DDCR position.
- There are four risk zones when assessing restructures to deal with DDCR compliance, as follows:
    - *White zone: further risk assessment not required* - restructures determined by ATO to be low risk.
    - *Green zone: low risk* - all restructures are consistent with low-risk examples in the PCG.
    - *Yellow zone: risk not assessed* - taxpayer has at least one restructure not covered by an example in the PCG.
    - *Red zone: high risk* – at least one restructure consistent with high-risk examples in the PCG.
- Example 9 involves third-party debt being used for multiple purposes, including a purpose caught by the DDCR rules, and then is ultimately refinanced with related party debt. The PCG suggests that DDCR applies to the related party debt to the extent it was used to refinance third party debt that was used for a purpose caught by the DDCR.
- Examples 15, 16 and 17 are new examples on the fair and reasonable identification of disallowed debt deductions through apportionment. These examples show that if it is not possible to trace the use of funds, apportionment may be appropriate. However, the examples are simplistic and assume that the use of funds can be clearly identified.
- Examples 20 and 21 set out a low-risk restructure where related party debt is replaced with third party debt. The refinancing is considered low risk because it is not associated with (1) any broader refinancing of the group; (2) any back-to-back or connected arrangements; or (3) any associated reduction in third party debt of an associate. These examples suggest that if any of the noted factors do exist, then the refinancing of related party debt with third party debt may not be a low-risk restructure.
- Example 28 provides a high risk restructure where an Australian entity indirectly uses related party debt to fund its offshore operations, even where the related party debt is first used to repay third party debt, which is subsequently drawn dawn to indirectly fund the acquisition of assets from associate pairs by a subsidiary.

The ATO also released PCG 2025/2EC which is a compendium of comments on submissions made to the Commissioner on the draft PCG. This compendium provides further context on the ATO's approach when applying the DDCR.

While it is useful that the PCG has been updated with new examples and details, taxpayers may still have difficulty applying the PCG where their situation is not on "all fours" with such examples. It is important that taxpayers apply the (near) finalised PCG against their own facts and circumstances and perform their own risk assessment of the application of the DDCR and/or anti-avoidance provisions. This will also be important for the various disclosures now required in the International Dealings Schedule and Reportable Tax Position Schedule.

High Court victory for PepsiCo – no royalty withholding tax or diverted profits tax payable

On 13 August 2025, a 4:3 majority of the High Court dismissed the Commissioner's appeal against the Full Federal Court decision in *FC of T v PepsiCo Inc & Anor* [2025] HCA 30, finding that payments made by Schweppes Australia Pty Ltd (Schweppes), the Australian bottler of Pepsi and other beverages, to PepsiCo Beverage Singapore Pty Ltd (PBS) (an Australian resident) for concentrate were not attributable to a royalty for the use of intellectual property (IP) owned by PepsiCo Inc and Stokely-Van Camp Inc, a subsidiary of PepsiCo. Accordingly, such payments were not subject to royalty withholding tax nor Diverted Profits Tax ("DPT"). The majority judgement noted the following key points:

- Under the arrangements, Schweppes had obtained a licence to use the PepsiCo IP. It had an obligation to build PepsiCo's brands and strengthen the PepsiCo IP, which was regarded as sufficient consideration for the use of the IP.
- No part of the price paid for the concentrate was a licence payment but was for goods sold and delivered.
- The concentrate was ordered from and acquired from PBS (and not PepsiCo) and the payments were included in PBS' assessable income for Australian income tax purposes. The amounts were not "derived by" or "paid or credited" to PepsiCo for the purposes of the royalty withholding tax provisions.
- In respect of the DPT provisions, the taxpayers did not obtain a tax benefit in connection with the scheme as there was no postulate that was a reasonable alternative to entering into or carrying out the scheme.

The ATO has acknowledged the High Court's decision and are currently considering the decision and any broader impact it may have on the reasoning set out in draft Taxation Ruling TR 2024/D1 *Income tax: royalties – character of payments in respect of software and intellectual property rights*.

Although the taxpayer was ultimately victorious through the courts, the decision was not unanimous, with some judges finding in favour of the Commissioner. The case demonstrates that the ATO continues to look closely at arrangements that may involve embedded royalties and the application of the DPT provisions and highlights the importance of taxpayers being able to document and support their positions.

Bennetts v FC of T – Interest income derived on actual receipt

In *Bennetts v FC of T* [2025] ARTA 1092, the ART found that interest in respect of contributions made by the taxpayer to a "construction industry long service leave fund" was assessable upon receipt and not as it accrued each year. Pursuant to the trust deed and the rules of the fund, the taxpayer was only entitled to the interest once he had met the relevant period of continuous service, that there was a written request for payment and a determination made by the trustee. In this regard, under the trust deed, a beneficiary of the fund did not have "any right, title or interest of any nature to or in the Fund or … any Income … until the Trustee declares that the Beneficiary is presently entitled to it under clause 3.3". The taxpayer's expectation of the interest income, which was required to be calculated annually, did not amount to derivation of such income for tax purposes as there was no absolute entitlement to the interest. The ART rejected the taxpayer's argument of "constructive receipt" or "implied direction" and distinguished the case of *FC of T v McNeil* 2007 ATC 4223.

Are you eligible for the R&D Tax Incentive?

Australian resident companies that undertake eligible R&D activities may be eligible for the R&D Tax Incentive being either:

- For companies with annual turnover < $20m, a refundable tax offset of 18.5% above their company tax rate; or
- For companies with annual turnover ≥ $20m, a non-refundable offset, linked to their R&D intensity (R&D expenditure / total business expense in the period). This equates to 8.5% above their company tax rate for R&D intensities up to 2%, and 16.5% above their company tax rate for the balance of their R&D spend above the 2% threshold. Unused non-refundable offsets may be carried forward to future income years (subject to the company tax loss recoupment rules).

Eligible R&D activities span across a broad range of industries and activities, including, but not limited to, pharma/biotech, design and engineering, natural resources, software development, fintech, manufacturing, agriculture, etc., provided they meet the program's eligibility criteria. To claim the incentive, businesses must register their R&D activities with DISR within 10 months of the end of their income year and demonstrate that their R&D involves systematic experimentation to generate new knowledge or technology – i.e. 30 April 2026 for companies with a June 2025 year end. It is noted that a new online application form was launched in August 2025, replacing the previous portal form.

Contact

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