

# Tax Alert

ATO draft Practical Compliance Guideline - Determining 'debt quantum' in the context of Australia's thin capitalisation rules  
May 2025

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## At a glance

- The draft PCG outlines the ATO's compliance approach to transfer pricing analyses undertaken to evidence that the quantum of debt borrowings in Australia are arm's-length, as required under Australia's thin capitalisation rules.
- The draft PCG is narrow in scope relative to transfer pricing analyses likely to be required more broadly in relation to the thin capitalisation provisions. In particular, the PCG is applicable only to inbound cross-border **related party** debt, despite the ATO acknowledging the rules also apply to third-party debt).
- The format of the PCG is similar to other transfer pricing-focused PCGs issued by the ATO, including color-coded 'risk zones' and simplified illustrative examples of 'low' and 'high' risk scenarios, with the important exception that changing a taxpayer's "risk-score" can only be achieved by reducing debt quantum.
- The guidance is primarily qualitative in nature only, with matters such as the 'group policies and practices' presented as one of a series of 'factors that an entity may reasonably be expected to consider' as part of the determination of sources of funding.
- The PCG also outlines ATO expectations regarding the documentation expected in support of the transfer pricing position.
- How EY can help.

The ATO has released (29 May 2025) a draft Practical Compliance Guideline ([draft PCG 2025/D2](#)) '*Factors to consider when determining the amount of your inbound, cross-border related party financing arrangement - ATO compliance approach*', to provide risk-based guidance on the ATO's expectations regarding transfer pricing analyses undertaken in the context of Australia's earnings-based thin capitalisation rules. Notably, the draft PCG addresses issues associated with one fact pattern only - scenarios involving inbound related party debt, despite the ATO acknowledging the rules also apply to third-party debt. The draft PCG is open for comment until 30 June 2025.

Earnings-based tests now underpin Australia's thin capitalisation rules. One significant implication is that the transfer pricing provisions must now be applied and 'arm's length conditions' assessed in relation to both the price of any intercompany debt and the debt quantum. That is, Australia's transfer pricing rules must now be applied to evidence that the quantum of all debt borrowings in Australia are arm's-length. Draft PCG 2025/D2 provides some insight into the ATO's approach to the transfer pricing issues, albeit only in relation to arrangements involving inbound cross-border financing. Where the thin capitalisation rules apply, it is recommended that a transfer pricing analysis including an evaluation of the entity's 'arm's length capital structure' is undertaken.

The application of 'arm's length conditions' transfer pricing rules where the thin capitalisation rules apply is required from income years starting on or after 1 July 2023 (the same application date as for the new 'general class investors' thin capitalisation rules and associated changes). For covered entities with a substituted accounting period, this therefore first impacts income tax calculations for example in respect of 31 December 2024 income tax returns.

The draft PCG provides examples of two low-risk and three high-risk scenarios relating to inbound cross-border related party debt only. The examples are highly simplified, and therefore not overly informative and unlikely to be widely applicable. The broader 'risk assessment framework' provides some general qualitative signposts regarding certain of the factors the ATO considers to be relevant to the determination of 'the amount of a financing arrangement' - such as group policies and practices and the return to shareholders.

Consistent with other transfer pricing PCGs, arrangements are categorised into color-coded 'risk zones' which determine the ATO's compliance approach.

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## Overview of draft PCG 2025/D2

This draft PCG is the latest in a series of transfer pricing-focused PCGs released by the ATO. Consistent with the structure of prior PCGs, it contains examples designed to highlight features and characteristics of arrangements with different 'risk profiles' from the ATO's perspective, together with illustrative examples.

As set out in an earlier [EY tax alert](#), the move to earnings-based thin capitalisation rules had a direct transfer pricing impact. Before the ratio tests are applied it is necessary as a first step to demonstrate the entity's capital structure (i.e. their amount of debt borrowings relative to equity capital) is 'arm's length'. The earnings ratio tests are therefore best thought of as representing a cap on available debt deductions and not a safe harbor.

Our assessment of how the transfer pricing rules will apply in relation to the determination of the quantum of debt is that it is analogous (but not identical) to the arm's-length capital structure analysis required under the predecessor provision arm's-length debt test in Division 820 ITAA 1997. This would typically involve an analysis of borrowing capacity with reference to relevant financial ratios that an independent lender would consider, as well as debt/equity and risk profile that would be acceptable in the market.

The draft PCG does not contain quantitative indicators, rather the guidance is focused on qualitative and directional pointers regarding factors that may inform risk. For example, it is anticipated that 'options realistically available' to the Australian taxpayer are considered having regard to the following:

- Circumstances where the use of **internally generated funds** would be preferred in light of the taxpayer's situation
- Scenarios where the use of **debt capital** may be appropriate
- Specific circumstances where the use of **equity capital** would be preferred

Factors relevant to the determination of the amount of any financing arrangement are specified as involving:

- The '**funding requirement**' or purpose for which the debt capital is required
- **Group policies and practices** as relevant to the borrowing decisions of the Australian taxpayer
- The **return to shareholders** in light of the financing arrangement
- The need to minimise the **cost of funds** as relevant to the quantum of debt
- The existence of financial **covenants** as relevant to decisions regarding the quantum of debt

- Existence of any explicit guarantees as relevant to the taxpayer's borrowing capacity
- Forms of security provided as relevant to a lender's decision
- The ability of the borrower to service its debt obligations ('**serviceability**') is one of two areas where the draft PCG includes reference to quantitative approaches. In this context, interest coverage and debt service coverage ratios are referenced as the common-use approaches adopted by lenders
- The other area where quantitative approaches are referenced relates to **leverage**, with leverage ratio; debt to equity; debt to assets; and loan to value the indicators referenced

## Compliance approach

Consistent with other transfer pricing PCGs the risk assessment framework provides guidance regarding the level of compliance resources the ATO will apply in relation to the following four 'risk zones':

Risk zone	Risk level
White	Arrangements already reviewed and concluded
Green	Low-risk
Blue	Compliance risk not assessed
Red	High-risk

Guidance in relation to 'low-risk' and 'high-risk' zones is limited in light of the highly simplified examples. For example, Example 1 (low-risk) outlines a scenario where no interest is deducted on related party debt with the unremarkable conclusion this would be 'low-risk' from the ATO's perspective. At the other end of the spectrum, the high-risk examples are limited in their usefulness:

- Example 3 involves a scenario where 30% of the inbound related party debt is held in cash reserves; with the cash reserve attracting interest that is <90% of the 'cost' of the related party debt. Unremarkably, a 'high risk' scenario is one where the interest deduction exceeds the interest income.
- Example 4 involves the existence of a formal guarantee and the guarantee has enabled the Australian taxpayer to borrow a greater amount of debt than it would otherwise absent the guarantee. This is also presented as 'high-risk'.
- Example 5 describes a 'high risk' fact pattern similar to Example 3 while adding an arbitrary (and restrictive) \$30m debt deduction threshold as relevant to the 'high risk' conclusion.

In that regard, it is reasonable to assume the majority of taxpayers with inbound related party debt would therefore be located in the 'blue' zone ('blue zone' is defined as arrangements not in the white zone or not covered by a low-risk or high-risk example in the draft PCG), and there is no specific guidance that further differentiates those that are 'other than' the low or high-risk examples.

## Documentation and evidence

Referencing the general record keeping rules, the direction is that taxpayers with an inbound cross-border financing arrangement should 'maintain documentation and evidence to support your transfer pricing position, for each income year that financing arrangement remains on issue'. Additionally, the draft PCG includes a detailed and specific documents and workings that the ATO may request. These include:

- Transfer pricing analysis undertaken
- Information (e.g. funding proposals) that demonstrates your consideration of the funding options 'realistically available'
- Calculations or workings that show the evaluation of returns to shareholders (or investors) or other financial benefits
- Documentation or workings that consider the impact of the debt on the overall cost of (debt) capital (including correspondence with third parties, such as lenders or credit rating agencies)
- Information regarding the purpose for which the funds were required

## Other comments

In our experience, there is uncertainty regarding the circumstances where transfer pricing analyses would be required in the context of the third-party debt test. In our view it cannot be assumed that election of the third-party debt test does not require a transfer pricing analysis in support and notably the draft PCG is limited only to inbound cross-border related party debt arrangements.

As noted, the examples illustrating low and high-risk scenarios are of limited utility and there is also no guidance in relation to attributes that may mean relatively more or less in terms of expected levels of analysis and documentation.

## How EY can help

The EY transfer pricing team can assist you in addressing the specific issues raised in this draft PCG, and more generally in relation to the transfer pricing analysis required as part of the thin capitalisation provisions.

For more information please  
contact your usual EY advisor or:

Sydney:

Jarrold Thomas  
Tel: +61 2 9276 9689  
[jarrod.thomas@au.ey.com](mailto:jarrod.thomas@au.ey.com)

David Tracey  
Tel: +61 2 9248 4885  
[david.tracey@au.ey.com](mailto:david.tracey@au.ey.com)

Tony Do  
Tel: +61 2 9276 9925  
[tony.do@au.ey.com](mailto:tony.do@au.ey.com)

Sam Lavender  
Tel: +61 2 8295 6739  
[sam.lavender@au.ey.com](mailto:sam.lavender@au.ey.com)

Sophie Lewis  
Tel: +61 2 8295 6646  
[sophie.lewis@au.ey.com](mailto:sophie.lewis@au.ey.com)

Patrick Giles-Jones  
Tel: +61 2 9248 4170  
[patrick.giles-jones@au.ey.com](mailto:patrick.giles-jones@au.ey.com)

Jason Vella  
Tel: +61 2 9248 4613  
[jason.vella@au.ey.com](mailto:jason.vella@au.ey.com)

Jesper Solgaard  
Tel: +61 2 8295 6440  
[jesper.solgaard@au.ey.com](mailto:jesper.solgaard@au.ey.com)

Danielle Donovan  
Tel: +61 2 8295 6333  
[danielle.donovan@au.ey.com](mailto:danielle.donovan@au.ey.com)

Brisbane:

Kevin Griffiths  
Tel: +61 7 3243 3754  
[kevin.griffiths@au.ey.com](mailto:kevin.griffiths@au.ey.com)

Melbourne:

Ed Ng  
Tel: +61 3 9655 2672  
[edward.ng@au.ey.com](mailto:edward.ng@au.ey.com)

Michael Jenkins  
Tel: +61 3 8664 9812  
[michael.jenkins@au.ey.com](mailto:michael.jenkins@au.ey.com)

Julian Hine  
Tel: +61 3 9655 2923  
[julian.hine@au.ey.com](mailto:julian.hine@au.ey.com)

Perth:

Joe Lawson  
Tel: +61 8 9429 2489  
[joe.lawson@au.ey.com](mailto:joe.lawson@au.ey.com)

Caroline Walker  
Tel: +61 8 9217 1897  
[caroline.walker@au.ey.com](mailto:caroline.walker@au.ey.com)

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