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New thin capitalisation regime details released

The Australian Treasury released Exposure Draft legislation aimed at strengthening Australia's thin capitalisation (Thin Cap) rules. The Government is seeking feedback on the Exposure Draft which also proposes to disallow interest on debt used to fund foreign companies.

24/3/2023

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The Exposure Draft, released on 16 March 2023, is in line with the Government's commitment to address tax avoidance practices of multinational enterprises and streamline with (OECD) best practice guidelines. To learn more about the previous announcements, see our article about the Proposed changes to Australia's thin capitalisation rules.

From 1 July 2023, the new proposed thin cap provisions will replace the existing rules and limit the amount of interest deductions for certain entities. With 3 months before its intended commencement, the Government has finally released a draft of the new rules. The Exposure Draft legislation is open for consultation until 13 April 2023 with submissions to the Australian Treasury.

Who do the new thin cap rules apply to?

The new regime applies to:

- foreign controlled taxpayers and taxpayers with foreign operations. These remain broadly unchanged from the existing rules
- only applies to general investors and, in part, to financial entities
- certain exemptions will continue to apply – including the $2 million (debt deduction) de minimis exemption.

What are the new tests?

The new regime's safe harbour will be broadly based on the taxpayer's current year taxable income – instead of the current safe harbour which is based on a taxpayer's balance sheet.

The new safe harbour will be known as the Fixed Ratio Test (FRT). The FRT will limit interest deductions to 30% of a taxpayers Tax EBITDA. The Tax EBITDA will broadly be calculated as a taxpayer's taxable income adjusted for interest deductions, losses and tax depreciation. Any non-deductible interest can be carried forward for 15 years.

Two other tests will be available:

1. The **Group Ratio Test** (broadly replacing the worldwide gearing test)
2. The **External Third Party Debt Test** (broadly replacing the arms length debt test).

The Group Ratio Test will apply to disallow interest deductions by applying a group ratio to the taxpayer's tax EBITDA – instead of the 30% FRT. The group ratio is calculated by applying a complex formula broadly equal to the third party interest expense of the global group divided by the Group EBITDA.

As the name suggests, the External Third Party debt test will only apply to debt issued to external parties – meaning taxpayers may no longer be able to deduct interest issued to related parties even where third parties would have loaned funds on the same terms.

Other changes

The Government also proposes to repeal current provisions that allow interest and debt deductions referrable to foreign investments. Under the exposure draft, interest would not be deductible where it was referable to the derivation of non-assessable non-exempt dividend income.

What are the details of the rules?

A more detailed analysis of the exposure draft proposals is contained in our Technical Briefing in the Appendix. We encourage you to talk to the SW team to understand these changes further.

Application Date

The new legislation is set to apply to income years commencing on or after 1 July 2023. Disappointingly, there is still uncertainty on the application date for entities that are early balancers (for example, the entity has a 31 December year-end).

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How should taxpayers prepare?

We recommend that taxpayers start planning for the draft legislation to be implemented on 1 July 2023. Whilst we expect there to be minor technical amendments, the draft legislation is predominantly based on the OECD guidance.

Therefore, restructuring debt arrangements may be necessary, and transaction documentation needs revisiting prior to 30 June 2023.

Taxpayers should consider whether restructuring debt arrangements are necessary and the impact of doing so.

How can SW help?

Our SW team can assist with:

- modelling the potential impact of the new rules on your debt deductions
- assessing the feasibility of restructuring the financing structure of the group
- considering whether one of the alternative tests would be applicable and beneficial to your circumstances.

Reach out to your SW advisor for support from our specialist tax team.

Technical Briefing

On 16 March 2023, the Australian Treasury released draft legislation for comment, introducing fundamental changes to Australia's thin capitalisation rules for income years beginning 1 July 2023.

For entities that are 'general class investors' (refer further below) the existing thin capitalisation rules will be replaced with the following tests:

- Fixed Ratio Test (FRT)
- Group Ratio Test (GRT) and
- External third-party debt test.

The newly introduced earnings-based rules for 'general class investors' are aimed at reducing risks to the Australian domestic tax base from the use of excessive debt deductions. As mentioned in the Explanatory Memorandum, the new rules are intended to be more restrictive than the existing thin capitalisation rules and entities should generally expect harsher outcomes relative to the existing tests.

Who do the measures apply to?

As noted above, the new rules apply to 'general class investors'. A general class investor is essentially an entity to which the existing thin capitalisation rules apply, other than a 'financial entity' or an 'approved deposit taking institution' (ADI), and would comprise any other:

Australian entity or Australian permanent establishment that is controlled by a foreign person or Australian entity that controls a foreign entity or foreign permanent establishment.

In good news, the following exemptions from thin capitalisation have been retained and continue to apply:

- $2 million (debt deduction) de minimis exemption
- 90% Australian asset exemption (outward entity with 90% or more of their assets based in Australia)
- Securitisation vehicle exemption

For financial entity and ADIs, the existing thin capitalisation rules would be maintained, subject to two important changes, in that the proposed legislation:

- narrows down the definition of financial entity to further restrict the existing concessionary safe harbour gearing rules applicable to financial entities, and
- replaces the existing arm's length debt test available to financial entities (that are not ADIs) with the stricter external third party debt test referred to below.

What are the new measures?

A brief outline of the key elements of the new tests and conditions is provided in the table below, with more detail of elements referred to in the table set out following.

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New test	Previous test	Application
FRT	Safe harbor debt test	The FRT will apply by default unless the taxpayer chooses to apply another method. FRT disallows net debt deductions (i.e. debt deductions net of income in the nature of interest) that exceed the Fixed Ratio Earnings Limit (i.e. 30% of 'tax EBITDA' (the meaning of which is explained below)). A 15-year carry forward rule applies to total amounts that were disallowed under the FRT as long as the taxpayer continues to use FRT, with a special deduction potentially being available in later years (explained in more detail below).
GRT	Worldwide gearing debt test	The purpose of the GRT is broadly to permit a highly leveraged multinational groups the opportunity to claim higher interest deductions than would be permitted under the default FRT. A choice can be made by a general class investor to apply the GRT for an income year as an alternative to the FRT only where: • the entity is a 'GR group member' (that is, consolidated in the GR group's consolidated financial statements on a line by line basis), and • the 'GR group EBITDA' is not less than zero. GRT disallows net debt deductions that exceed the 'group ratio earnings limit' (explained in further detail below, but essentially a group-based EBITDA concept). Whilst potentially beneficial to highly leveraged groups, this approach will often involve complex calculations and practical challenges, as explained in more detail below.
External third-party debt test	Arm's length debt test	The test will be available by choice to general class investors in relation to an income year, subject to an important proviso noted below and financial entities. For general class investors, the choice will need to be made by all associate entities – there is a 'one-in all-in' requirement for associate entities of general class investors. This test is much more restrictive than the existing arm's length debt test, as explained in more detail below, in that its focus is limited to debt deductions applicable to borrowings from unrelated parties. This test disallows debt deductions that exceed the entity's external third-party earnings limit.

Tax EBITDA

Tax EBITDA is an entity's taxable income (including prior year tax losses recouped) adjusted to exclude the following items:

- net debt deductions for the income year
- the sum of the entity's decline in value (depreciation) and capital works deductions (that is, tax depreciation).
- any prior year tax losses claimable in the year.

If the result of the last step is negative, the tax EBITDA is zero.

Special deductions (carry forward rule under FRT)

Under the new rules, entities that had debt deductions disallowed under the FRT (FRT disallowed amounts) over the past 15 years can claim a special deduction in certain circumstances. This is particularly relevant for entities with low earnings in their early years of operation.

The special deduction is only allowed where:

- the entity has continued to use the FRT between the disallowance year and the deduction year, and
- for companies, a modified version of the continuity of ownership test is passed in relation to each FRT disallowed amount sought to be claimed. Interestingly, there are no similar requirements for trusts or other entities.

The special deduction each year will be limited to the amount by which the taxpayer's fixed ratio earnings limit exceeds their net debt deductions for the income year (meaning that the 30% tax EBITDA cap will apply in the deduction year). Entities can then apply each of their FRT disallowed amounts for the previous 15 income years against that excess.

Modifications have been made to the income tax consolidation rules to allow FRT disallowed amounts to be brought into a tax consolidated group when an entity joins the group.

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Group Ratio Test (GRT)

Under the new earnings based GRT, an entity's debt deductions will be disallowed to the extent that the net debt deductions exceeds the entity's 'group ratio earnings limit'.

The 'GR group' is the group comprised of the worldwide parent entity and all other entities fully consolidated on a line-by-line basis in the parent's audited consolidated financial statements.

Under the GRT, there is no ability to carry forward denied deductions and any previous year's denials calculated under a previous application of the FRT will be forfeited if an entity elects for the application of the GRT prior to the recoupment of any carry forward denial amounts.

The 'group ratio earnings limit' for an entity is the product of:

- the 'group ratio' for the income year, and
- the Tax EBITDA for the entity for the income year.

The group ratio is calculated as the 'GR group net third party interest expense' divided by the 'GR group EBITDA'.

The OECD guidance on the group EBITDA based thin capitalisation measures included three different models that balanced simplicity and compliance obligations. Unfortunately, it appears that Australia has adopted an onerous model in relation to GRT that will require significant calculations and understanding of the global group to determine the GR group EBITDA and net third party interest expense. For small sized subsidiaries in Australia that have trouble accessing information from larger parent entities, the GRT may be impractical.

The GR group net third party interest expense will be the amount that is included as net third party interest expense in the group's financial statements for the period. However, adjustments to the groups consolidated financial statements may or will be required to:

- include an amount in the nature of interest and any other amount that is calculated with reference to the time value of money as if it was interest, and
- exclude interest payments to certain associate entities that are outside the GR group.

The GR group EBITDA is the sum of the following:

- net profit (excluding tax expense) of the GR group
- Adjusted GR group net third party interest expense, and
- depreciation and amortisation expense of the GR group.

However, where the EBITDA of any entity, within a GR group, is less than zero, the entity's EBITDA will be excluded from the GR group EBITDA. Practically, this will require the analysis of the financial statements of each entity within a GR group, as opposed to relying on group consolidated financial statements to determine the GR group EBITDA. Depending on the size and/or complexity of a GR group, this may be a costly and burdensome process.

An entity must keep records of the group ratio showing the particulars that have been taken into account in the calculation. These records must be prepared prior to the lodgement of the entity's income tax return for the income year the group ratio relates to. These records are required to be maintained for five years and may need to be made available for potential tax audits in the future.

External third-party debt test

The external third-party debt test is a new test that disallows debt deductions exceeding those attributable to external third-party debt. It may be beneficial to taxpayers in circumstances where external lenders have adopted a more highly geared position than allowed for under the FRT. Again, the adoption of this test will result in the forfeiture of any deductions denied and carried forward under the FRT. The concept of external third-party debt is a limited one – it is a debt interest that satisfies the following conditions:

- the debt interest was issued to an entity that is not an associate of the borrower
- the debt interest was not held by an associate (preventing assignments to associates post issuance)
- the holder of the debt has recourse only to the assets of the borrowing entity
- the entity uses the proceeds of the debt only to:
  - fund Australian operations, and
  - invest in assets for the purpose of producing assessable income or assets that are attributable to an Australian permanent establishment.

The application of the test will therefore not apply in situations where there is either:

- guarantees provided by parent entities or parties other than the borrower and
- security taken over assets of any party other than the borrower.

However, in good news, the draft legislation includes a concession for entities that are finance vehicles for a group (referred to as conduit financer in the draft legislation). The finance vehicle exemption only applies (amongst other things) where the terms of the finance are back-to-back on identical terms other than quantum of the loans with the lender's recourse being limited to the assets of the ultimate borrower and the relevant loan asset of the conduit financier. In addition, the conduit financier concession will generally only apply where the conduit financer is an Australian resident taxpayer (or, if not, derives assessable income in Australia).

This concession extends the external third-party debt alternative to the ultimate borrowing entity.

Australian borrowings to fund foreign investments

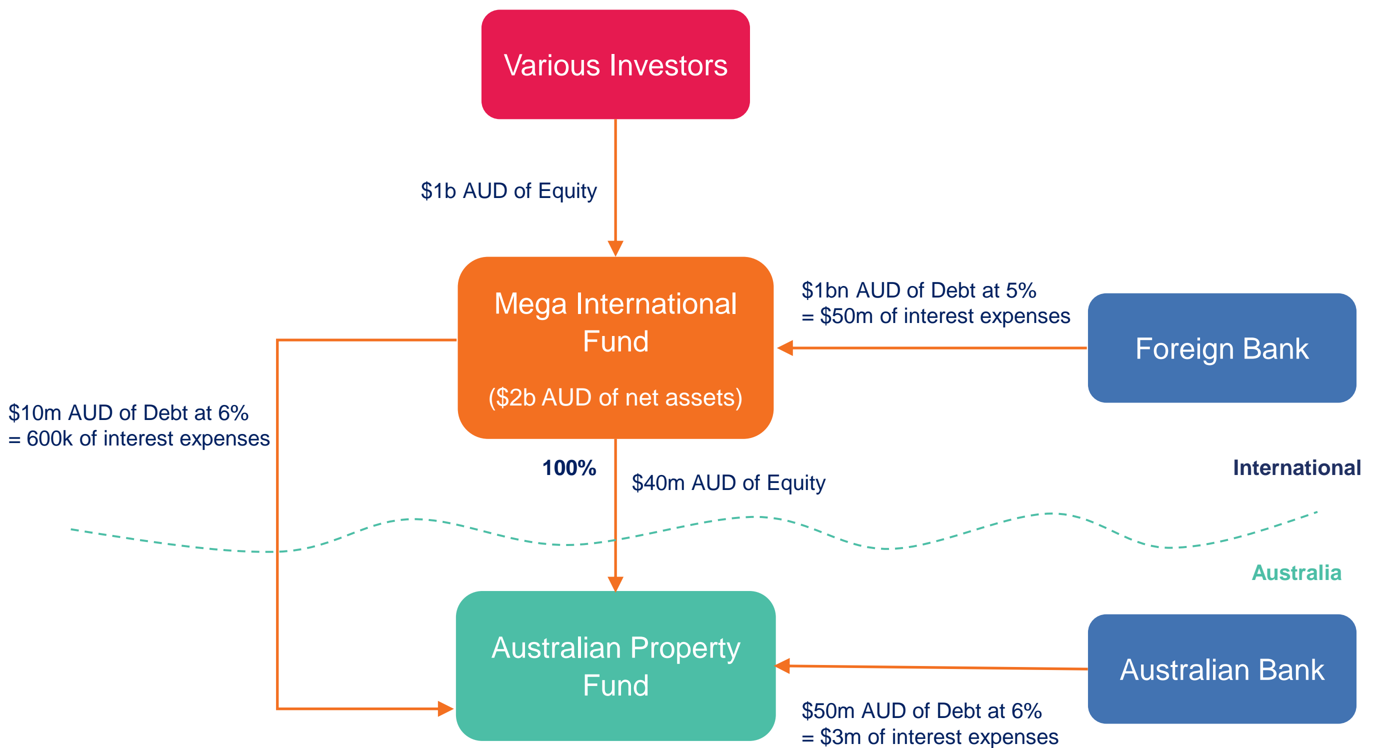
Under sections 25-90 and 230-15 of *the Income Tax Assessment Act 1997 (Cth)* (ITAA 1997) an entity can claim a deduction for a cost in relation to a debt interest incurred to derive foreign non-assessable non-exempt income. Typically, Australian holding companies of global business used the provision to deduct interest expenditure incurred to acquire foreign subsidiaries.

However, the provisions are to be amended in order to prevent debt deductions from being claimable in relation to derivation of income that is non-assessable non-exempt under section 768-5 of the ITAA 1997 (about participation exemption for dividends).

Relevant dates

The government is seeking stakeholders' views on the exposure draft legislation and accompanying explanatory material implementing this measure and consultation is currently underway with the closing date of 13 April 2023.

The new legislation is set to apply to income years commencing on or after 1 July 2023. Clarification of the commencement date will be required for entities that are early balancers (for example, the entity has a 31 December year-end).



	Taxable Income ($m)	Tax EBITDA ($m)
Business income	9.5	9.5
Interest income	0.5	
Interest expense – Australian Bank (AUD)	(3.0)	
Interest expense – Mega International Fund (AUD)	(0.6)	
Tax Depreciation (AUD)	(4.0)	
Other Expenses (AUD)	(5.0)	(5.0)
Tax (Loss) / Profit (AUD)	**(2.6)**	**4.5**

The disallowed amount under each test would be as set out in the table below:

Test	Disallowed amount	Calculation
FRT	Net debt deductions *less* fixed ratio earnings limit	Net debt deductions = $3.1m ($3.6m less $0.5m) Fixed ratio earnings limit = $1.35m ($4.5m * 30%) Disallowed amount = $1.75m ($3.1m less $1.35m)
GRT	Entity net debt deductions *less* entity's group ratio earnings limit	Net debt deductions = $3.1m ($3.6m less $0.5m) Entity's group ratio earnings limit = group ratio (50% - refer below) x tax EBITDA ($4.5m) = $2.25m Group ratio = group net third-party interest expense ($52.5m) divided by group EBITDA ($105m – being the assumed accounting net profit of Mega International Fund group) = 50% Disallowed amount: $0.850m ($3.1m less $2.25m)
External third-party debt test	Entity's debt deductions *less* entity's external third-party party earnings limit	Entity debt deduction = $3.6m Interest payable on external third-party debt = $3m. Note that the conduit rules would not apply to borrowings from the Foreign Bank as Mega International Fund would not satisfy the detailed conditions (all of which are required to be satisfied) of the conduit financier concessions, as: • it does not have an Australian PE or derive Australian taxable income, • Interest rate charged by Mega International Fund is higher than the 3rd party debt, and • Recourse conditions not satisfied. Disallowed amount: $600k ($3.6m less $3m)

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