

# Bill for new thin capitalisation regime introduced

**On 22 June 2023, the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (the Bill) was introduced into Parliament. The purpose of the Bill is to introduce fundamental changes to Australia's thin capitalisation rules for income years beginning 1 July 2023.**

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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
- **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 in the existing law 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 entities and ADIs, the existing thin capitalisation rules would be maintained, subject to two important changes, in that the Bill:

- adds two additional requirements for an entity to be a 'financial entity', being:
  - the entity carries on a business of providing finance but not predominantly for the purposes of providing finance directly or indirectly to or on behalf of the entity's associates and
  - the entity derives all, or substantially all, of its profits from that business.
- replaces the existing arm's length debt test available to financial entities (that are not ADIs) with the stricter 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, with more detail of elements referred to in the table set out following.

New test	Previous test	Application
FRT	Safe harbor debt test	<p>The FRT will apply by default unless the taxpayer chooses to apply another method.</p> <p>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)).</p> <p>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).</p>
GRT	Worldwide gearing debt test	<p>The purpose of the GRT is broadly to permit highly leveraged multinational groups the opportunity to claim higher interest deductions than would be permitted under the default FRT.</p> <p>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:</p> <ul style="list-style-type: none"> <li>the entity is a 'GR group member' (that is, consolidated in the GR group's consolidated financial statements on a line by line basis)</li> <li>the 'GR group' does not comprise of one entity and<sup>1</sup></li> <li>the 'GR group EBITDA' is more than zero.</li> </ul> <p>The worldwide parent or global parent entity in a GR group is referred to as the 'GR group parent' and must have financial statements that are audited consolidated financial statements for the period.<sup>2</sup></p> <p>GRT disallows <b>net debt deductions</b> that exceed the 'group ratio earnings limit' (explained in further detail below, but essentially a group-based EBITDA concept).</p> <p>Whilst potentially beneficial to highly leveraged groups, this approach will often involve complex calculations and practical challenges, as explained in more detail below.</p>
Third-party debt test	Arm's length debt test	<p>The test will be available to financial entities and by choice (or a deemed choice) to general class investors in relation to an income year.</p> <p>Broadly, if an entity that issues a debt interest chooses to use the third-party debt test, then their associate entities in the obligor group in relation to the debt interest are all deemed to have also chosen to apply the third-party debt test.</p> <p>An entity is a member of an obligor group in relation to a debt interest if:</p> <ul style="list-style-type: none"> <li>the creditor of that debt interest has recourse for payment of the debt to the assets of the entity and</li> <li>the obligor entity is an associate entity of the borrower (based on a 20% TC control interest test).</li> </ul> <p>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.</p> <p>This test disallows debt deductions that exceed the entity's third-party earnings limit.</p>

<sup>1</sup>Para 2.35 of EM

<sup>2</sup>Para 2.36 of EM

## Concept of debt deduction expanded

The thin capitalisation rules apply to limit the amount of net debt deductions for an entity. The Bill amends the definition of debt deductions to align with OECD guidance. Previously a debt deduction was a cost in relation to a debt interest issued by the entity. However, the new definition does not require a direct nexus to the debt interest and is intended to capture anything that is economically equivalent to interest (for example, payments under an interest rate swap). Note, however, that the focus of the new thin capitalisation provisions is on the net debt deductions of an entity, which has regard to both the expanded concept of debt deductions incurred and an expanded concept of interest-like receipts.

## Tax EBITDA

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

- net debt deductions for the income year
- the sum of the entity's deductions under Division 40 and 43 (except amounts that are immediately deductible)<sup>5</sup>
- dividends and franking credits
- distributions from trusts or partnerships where the trust or partnership is an associate entity of the recipient entity (note that an entity will be an associate entity for these purposes where, in broad terms, the entity has a stake of 10% or more).

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

The exclusion of distributions from tax EBITDA is a major change from the Exposure Draft. The rationale for the change is to ensure that the same income is included only once in a Tax EBITDA calculation. However, for groups where the debt is provided to a head entity that subscribe for equity in subsidiary entities, the proposed changes will have significant consequences. This is particularly onerous as no excess debt capacity in the subsidiary entity can be utilised by the head entity.

## 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
- for companies, a modified version of the continuity of ownership test is passed in relation to each FRT disallowed amount sought to be claimed and
- for trusts, a modified version of the trust loss rules is passed in relation to each FRT disallowed amount sought to be claimed.

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.

## 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 exceed 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 economically equivalent to interest, and
- exclude interest payments to certain associate entities (broadly, where a 20% stake is held) 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.

<sup>5</sup>Para 2.58 of EM – deductions for tax losses from earlier income years is removed for calculating EBITDA

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 in a manner that a reasonable person could understand prior to the lodgement of, or requirement to lodge, 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.

### Third-party debt test

The third-party debt test is a new test that disallows debt deductions exceeding those attributable to third-party debt. For these purposes, debt deductions of an entity that are:

- directly associated with hedging or managing the interest rate risk in respect of the debt interest (this is intended to only cover conventional interest rate swap arrangements) and
- not referable to an amount paid, directly or indirectly, to an associate entity of the entity
- are taken to be attributable to the third-party debt interest.<sup>7</sup>

The third-party debt test 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 third-party debt is a limited one – it is a debt interest that satisfies the following conditions:

- the entity is an Australian resident
- 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 Australian assets of the borrowing entity and are not rights under a guarantee, security or other form of credit support, other than where specified circumstances apply (see below)<sup>8</sup> and
- the entity uses all, or substantially all, of the proceeds of the debt only to fund its commercial activities in connection with Australia.<sup>9</sup>

Recourse to a credit support right will be permitted where the right relates wholly to development or creation of a CGT asset that is (or reasonably expected to be) real property situated in Australia. This concession is intended to cover greenfield investments or development projects where an entity would not have sufficient assets to secure funding. However, once the entity moves past the development phase of the project, the concession would cease to apply.

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, the Bill includes a concession for entities that are finance vehicles for a group (referred to as conduit financier in the Bill). The finance vehicle exemption only applies (amongst other things) where the terms of the finance are back-to-back on the same terms other than:

- quantum of the loans
- recovery of reasonable administrative costs and
- recovery of costs of the conduit financier that are debt deductions.

The ultimate lender's recourse must be limited to the assets of the ultimate borrower and the relevant loan asset of the conduit financier (additionally, both assets and entities must be sufficiently connected to Australia and the relevant Australian business operations).<sup>10</sup> In addition, the conduit financier concession will only apply where the conduit financier is an Australian resident taxpayer and the source of funding is from third parties - that is, an entity cannot use retained earnings to on lend).

Where the conduit financier conditions have been met, the debt deductions of an entity exclude costs associated with managing interest rate risk. Therefore, cost associated with interest rate swaps would be non-deductible.

The Explanatory Memorandum indicates that the third-party debt test is not intended to impede genuine commercial arrangements. However, due to the restrictive nature of the rules, most genuine third-party arrangements would not be able to satisfy the third-party debt test, including situations where external lenders require:

- parental guarantees or security over the shares in the conduit financier entity or
- in a head trust / sub trust investment structure (where finance is provided to a head trust), security over the real property held by a sub trust.



<sup>7</sup>Para 2.95 of EM

<sup>8</sup>Para 2.96 of EM; see para 2.100 for specified circumstances; credit support right is a new concept

<sup>9</sup>Para 2.96 of EM

<sup>10</sup>Para 2.109 of EM

## Australian borrowings to fund foreign investments

In good news, sections 25-90 and 230-15 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997) have been retained. An entity can claim a deduction for a cost in relation to a debt interest incurred to derive foreign non-assessable non-exempt income. However, the changes in the Bill to the thin capitalisation measures will limit the availability of debt deductions for Australian holding companies of international groups.

### Debt deduction creation rules

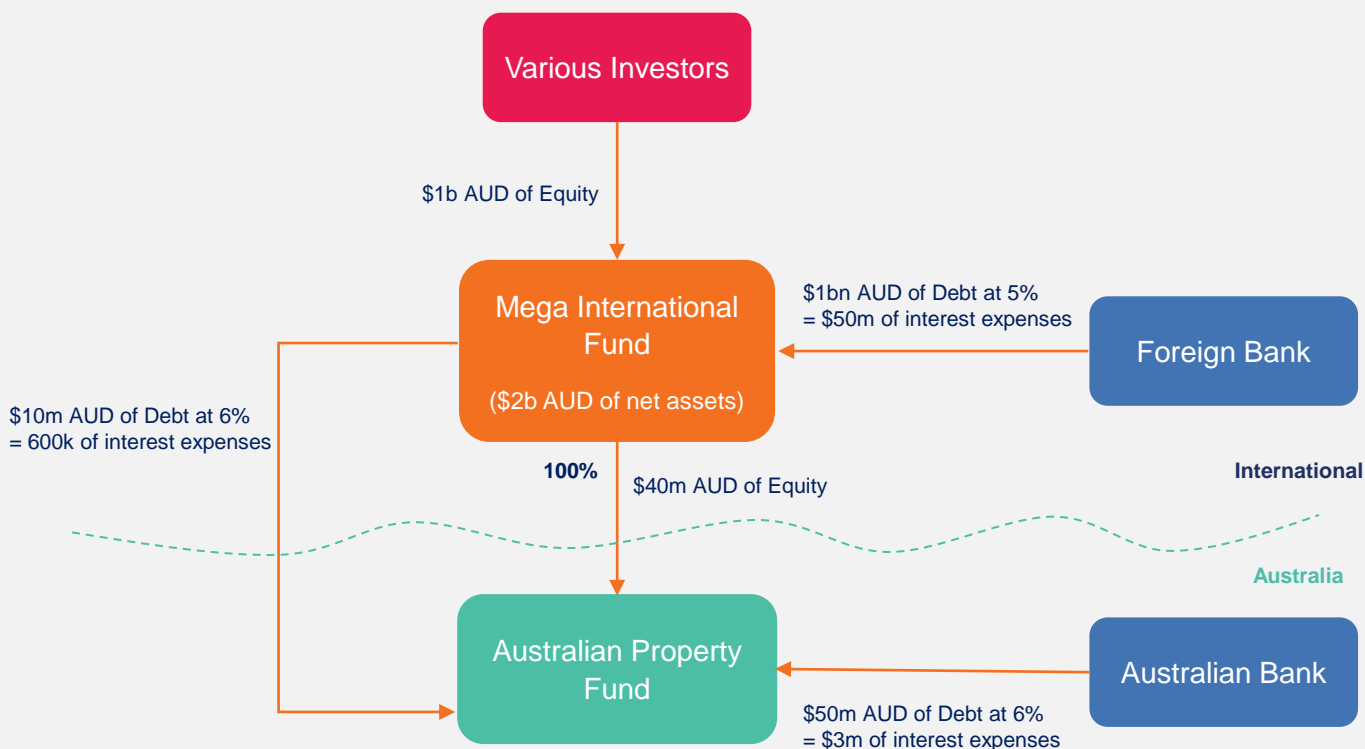
The proposed Bill introduces Subdivision 820-EAA on debt deduction creation rules, which will disallow debt deductions to the extent that they are incurred in relation to debt creation schemes that lack genuine commercial justification. The debt creation rules only apply to entities that are subject to thin capitalisation measures.

Subdivision 820-EAA will disallow debt deductions in the following two cases:

- The first case broadly involves an entity acquiring an asset (or obligation) from its associate (for example, the Australian entity acquires shares or assets from an associate and used debt to fund the acquisition). The debt deductions are disallowed to the extent that they are incurred in relation to the acquisition, or subsequent holding, of the asset. A typical example would be the acquisition of assets from a foreign associate that was vendor financed.
- The second case broadly involves an entity borrowing from its associate to fund a payment to that, or another, associate. The debt deductions are disallowed to the extent that they are incurred in relation to the borrowing.

In the second case, payments will include any amount credited, reinvested, applied to the benefit of another entity, settled on a net basis or on a non-cash basis, and the forgiveness of a debt. Payments may also include amounts of capital, such as returns of capital and repayments of principal under a debt interest.

## Example



Australian Property Fund	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)
<b>Tax (Loss) / Profit (AUD)</b>	<b>(2.6)</b>	<b>4.5</b>

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)
Third-party debt test	Entity's debt deductions less entity's third-party party earnings limit	Entity debt deduction = \$3.6m Interest payable on third-party debt = \$3m. Note that the conduit rules would not apply to borrowings from the Foreign Bank as Mega International Fund is not an Australian resident. Disallowed amount: \$600k (\$3.6m less \$3m)

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