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Tax Insights

Changes to debt deduction rules

Snapshot

Following the election on 21 May 2022, the Labor Party will form the new Government with Anthony Albanese as Prime Minister and Jim Chalmers as Treasurer. The Assistant Treasurer is Stephen Jones, and Andrew Leigh is the Assistant Minister for Competition, Charities and Treasury.

The new Labor Government announced a number of multinational tax measures during the election campaign (Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax, 27 April 2022[1]):

- Supporting the OECD Two Pillar solution
- **Limiting debt related deductions by multinationals in line with the OECD approach**
- Limiting the ability for multinationals to abuse Australia's tax treaties when holding intellectual property in tax havens
- Introducing various transparency and disclosure measures.

In addition, a further announcement on 19 May 2022 proposed an extension and boosting of existing ATO programs (Tax Avoidance Taskforce, Black Economy Taskforce) resulting in additional forecast net revenue of $3 billion over 2022-23 to 2025-26. This is in addition to existing ATO funding including that announced by the Coalition in the 2022-23 Federal Budget.

This Tax Insights addresses the policy of the new Government to limit debt related deductions incurred by multinationals.

Policy: EBITDA interest restriction rules

At present, very limited detail is available. The 2022 Labor policy proposes to limit "debt-related deductions by multinationals at **30 per cent of profits**, consistent with the OECD's recommended approach, while maintaining the **arm's length test** and the **worldwide gearing ratio**".

The limited further detail announced by the Labor Party so far is set out below:

- "Creating artificial debts and repayment arrangements within related entities is one of the main strategies multinational groups use to minimise their profits in higher tax countries to avoid tax.
- **From 1 July 2023** we will adopt the OECD's recommended approach for debt deductions within the allowed range to limit net interest expenses to **30% of profits**, measured using taxable earnings before interest, taxes depreciation and amortisation.
- We will ensure we are targeting tax minimisation and firms may be able to make further deductions if they can substantiate those under the **arm's length test** or **worldwide gearing ratio test.**
- Many countries around the world have adopted similar approaches including the US, UK, Germany, Japan, Sweden, Norway, Spain and many other European countries".

[1] Labor's Plan To Ensure Multinationals Pay Their Fair Share Of Tax , https://jimchalmers.org/latest-news/media-releases/labor-s-plan-to-ensure-multinationals-pay-their-fair-share-of-tax/

Key issues

Having regard to the limited detail available so far, the imminent start date (1 July 2023), the issues associated with the transition from the existing framework and the potentially significant commercial impact of the changes, set out below is a list of key issues that should be addressed in the consultation phase of this measure.

1. **Scope**: Which entities are in scope for the proposed new EBITDA rules?: will the scope match the current thin capitalisation regime?
2. Will there be any **transitional measures** in connection with implementation of the new framework?
3. What is the relevant scope and definition of **debt deduction** which will be affected by the new EBITDA regime?
4. What is the relevant scope and definition of **depreciation** and **amortisation** for the purposes of calculating EBITDA?
5. How will the new EBITDA regime interact with the transfer pricing rules?
6. Will any **disallowed deductions** in a particular year (where net interest is more than 30% of EBITDA) be available for **carry forward or carry back**, or will those deductions be permanently disallowed?
7. Will any **unused capacity** in a particular year (where net interest is less than 30% of EBITDA) be available for **carry forward or carry back**?
8. Will the existing **arm's length debt test** remain as is or will it be modified given the move to an EBITDA framework?
9. Will there be any changes to the existing **worldwide gearing tests**? Will these also be changed to be on an EBITDA basis?
10. What rules will apply for **public-benefit projects**?
11. What rules will apply for **banks and insurance** companies?

We comment below on a number of these matters.

OECD recommended EBITDA approach

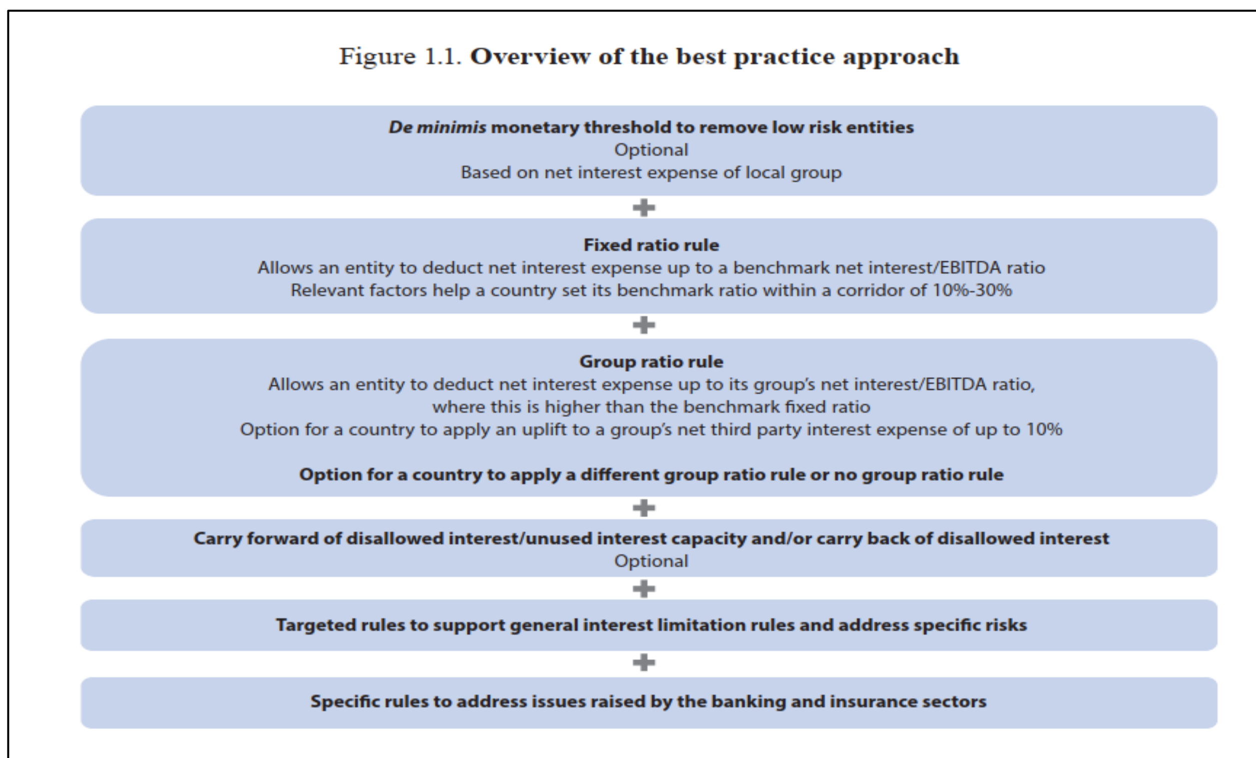
The genesis of the Labor policy is to be found in the BEPS Action 4 Report which recommended an EBITDA based approach, and which is widely adopted, especially in Europe.

BEPS Action 4 (Limiting base erosion involving interest deductions and other financial payments) addressed the "[development of] recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income".

The OECD BEPS work considered alternative approaches for a general interest limitation rule and in particular, whether such a rule should be based upon the relationship of **interest to earnings**, or the relationship of **debt to asset** values. The Report noted the relative volatility of an earnings based approach as compared to the relative stability of an asset based approach.

The October 2015 report concluded that "the **recommended approach** is based on a fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA)".

An overview of the OECD BEPS best practice approach is set out below:



Applying the EBITDA interest restriction rule

The Action 4 Report sets out the mechanics of the rule in a three-step manner, which is to be applied to a year of income.

Step 1: Calculating the measure of earnings

An entity's EBITDA should be calculated as follows:

(i) Commencing with **taxable income** (i.e., non-assessable non-exempt income not included in taxable income or EBITDA calculation)

add back the **tax values** for:

(ii) net interest expense and
(iii) depreciation and amortisation.

Step 2: Applying the statutory benchmark fixed ratio to earnings

Following the calculation of the entity's EBITDA, the statutory benchmark fixed ratio (e.g., 30% in the case of Australia) is applied to the EBITDA figure. The result determines the **maximum amount of interest expense that the entity is allowed to deduct** for tax purposes.

Step 3: Comparing maximum deductible interest expense (Step 2) with actual interest expense

The maximum amount that the entity is allowed to deduct for tax purposes (per step 2) is then compared with the entity's actual net interest expense. Where the actual net interest expense exceeds the maximum amount that the entity is allowed to deduct, the excess is to be treated as non-deductible.

Australian perspective

Australia's thin capitalisation laws had their genesis in the role of the Foreign Investment Review Board (FIRB) in examining proposals by foreign interests for investment in Australia and making recommendations to the government of the day on those proposals.

Prior to 1 July 1987, regulation of the capital structure of investments by foreigners into Australia was controlled by the FIRB. In 1987, a decision was taken to liberalise the Government's foreign investment policy and as part of this to introduce into the tax law, avoidance measures involving thin capitalisation and corporate restructuring. The rules prescribed a maximum debt to equity ratio.

Following recommendations of the Ralph Review of Business Taxation ('the Review'), the current thin capitalisation regime was introduced in 2001 by the *New Business Taxation System (Thin Capitalisation) Act 2001*. In broad terms, the general safe harbour approach allowed debt up to 75% (later reduced to 60%) of net assets, with net assets calculated based on the book value as recorded in the financial statements. Alternative approaches were also available via the world-wide gearing and arm's length debt tests.

The OECD BEPS Action 4 Report, whilst recommending an earnings-based approach also noted that:

> "Where the economy of a particular country is highly reliant on heavily capitalised groups whose activities rely on tangible fixed assets with long depreciation periods, earnings should still be a suitable measure of economic activity for the purposes of applying a fixed ratio rule. However, in this case **asset values may exceptionally be used as an acceptable alternative**"[2].

The initial response of the Australian government[3], presumably having regard to the above paragraph, noted that "*Australia has already tightened its Thin Capitalisation rules*", and no further changes to the deductibility of interest were proposed.

During the course of the 2019 election campaign, the Labor Party proposed a policy under which it would amend "the thin capitalisation rules to remove the safe harbour thin capitalisation and arm's length tests for interest deductions of multinational firms. This will leave the worldwide gearing ratio as the only deduction available." The 2022 Labor policy differs considerably to the 2019 policy.

We comment below on a number of **key issues** set out above.

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[2] Refer paragraph 83, OECD BEPS Action 4 Report, October 2015.

[3] Treasurer's Media Release, 6 October 2015, OECD report supports Australian Government action on multinational tax avoidance https://ministers.treasury.gov.au/ministers/scott-morrison-2015/media-releases/oecd-report-supports-australian-government-action

Scope of the proposed EBITDA regime

The current thin capitalisation measures broadly apply to:

- Australian entities that operate internationally
- Australian entities that are foreign controlled
- foreign entities that operate in Australia[4].

In addition, there are a number of key carveouts, in particular:

- Where total debt deductions of an entity and associates are $2 million or less (de minimis threshold);
- Certain entities where the Australian assets represent 90% or more of the total assets; and
- Certain entities associated with securitisation arrangements.

A critical issue which needs to be clarified for the market is whether the scope of the proposed EBITDA measure will be equivalent to the scope of the current thin capitalisation rules.

Start date and transitional arrangements

Clarification is required as to whether there will be any transitional measures for any existing loan arrangements or whether a hard start date is proposed, such that the new rules apply to existing and new loans.

In addition, whilst the policy announcement states that the new regime will apply from 1 July 2023, we presume that the new measures will apply to income years commencing on or after 1 July 2023, for example, with effect from 1 January 2024 for taxpayers with a December year end.

Scope of debt deductions affected

The existing thin capitalisation regime applies to debt deductions as defined in section 820-40. Clarification is required as to whether the existing definition of debt deduction will apply for the purposes of the EBITDA regime. The OECD Report takes a broad view as to the meaning of 'interest expense'.

Under the existing law, interest expense incurred in connection with the derivation of non-assessable non-exempt dividend income from foreign subsidiaries is prima facie deductible (e.g., section 25-90), subject to the operation of the thin capitalisation provisions. Confirmation should also be provided that this existing framework will continue.

Scope of depreciation and amortisation

In calculating EBITDA, the taxable income is grossed up for the tax values of depreciation and amortisation. Clarification is required as to the exact scope of depreciation and amortisation for these purposes. In particular:

- Does depreciation include all deductions available under Division 40, including immediately deductible expenditure (Subdivision 40-H) and section 40-880?
- Does depreciation include all deductions available under Division 43?
- Any additional amounts to be included, or any amounts to be excluded?

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[4] Refer section 820-30.

Disallowed interest and unused interest capacity

Under an EBITDA model, taxpayers are required to compare a relatively stable and predictable interest expense against a potentially volatile profit and EBITDA outcome. *Chapter 8 of the OECD Report: Addressing volatility and double taxation* deals with these concerns.

The OECD proposes that countries should consider smoothing the volatility through the use of average figures. For example, the test "could be applied to the average of EBITDA in the current year and, say, the previous two years".

Further, where in a particular year the actual net interest expense exceeds the maximum amount that the entity is allowed to deduct, the question arises as to how to treat the **disallowed interest**. The OECD notes whilst permanent disallowance may be an appropriate result in some cases, there will be other cases where "a permanent disallowance of interest expense would introduce a **level of uncertainty** for groups which could make **long-term planning difficult** and which a country may view as undesirable. A permanent disallowance of interest expense may also result in double taxation, if the lender is taxed on the corresponding interest income".

The converse situation is where the actual net interest expense in a particular year is less than the maximum amount that the entity is allowed to deduct. In that case, the question arises as to how to treat the **unused interest capacity** arising in that year.

Whilst the OECD best practice approach does not require a country to allow an entity to carry forward or carry back disallowed interest expense or unused interest capacity, the Report contemplates that countries may choose one of the following approaches:

- To carry forward disallowed interest expense only
- To carry forward disallowed interest expense and unused interest capacity
- To carry forward and carry back disallowed interest expense.

The European approach under the EU Anti-Tax Avoidance Directive[5] proposes the following similar approaches:

- To carry forward disallowed interest expense without time limitation
- To carry forward disallowed interest expense without time limitation and to carry back disallowed interest expense for a maximum of three years
- To carry forward disallowed interest expense without time limitation and to carry forward unused interest capacity for a maximum of five years.

The UK, Germany and France adopt the last of those approaches under their respective EBITDA regimes (carry forward disallowed interest expense without time limitation and carry forward unused interest capacity for five years).

[5] Anti-Tax Avoidance Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

Modelling the potential impact

As is evident from the above, there remain many significant policy and design features which need to be addressed and resolved, making it difficult for taxpayers to undertake preliminary modelling of the potential impact of the change.

Whilst it is necessary to make some assumptions, it is possible to use data in prior year tax returns to test the potential impact of the EBITDA regime relative to the thin capitalisation rules that applied for prior years.

In addition, taxpayers will need to start to factor in the potential impact of the EBITDA regime for future years. We can assist taxpayers in performing such modelling, and refine the analysis as the details of the EBITDA rules are finalised.

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Contacts

Mark Hadassin
Partner
Tel: +61 2 9322 5807
mhadassin@deloitte.com.au

Cindy Perryman
Partner
Tel: +61 3 8486 1231
cperryman@deloitte.com.au

Amelia Teng
Partner
Tel: +61 3 8486 1118
amteng@deloitte.com.au

Peter Radlovacki
Partner
Tel: +61 2 8260 4243
pradlovacki@deloitte.com.au

Scott Bailey
Partner
Tel: +61 2 9322 7171
scbailey@deloitte.com.au

Claudio Cimetta
Partner
Tel: +61 3 9671 7601
ccimetta@deloitte.com.au

Manu Sriskantharajah
Partner
Tel: +61 3 9671 7310
msriskantharajah@deloitte.com.au

David Watkins
Partner
Tel: +61 2 9322 7251
dwatkins@deloitte.com.au

Jonathan Schneider
Partner
Tel: +61 8 9365 7315
joschneider@deloitte.com.au

Jacques Van Rhyn
Partner
Tel: +61 7 3308 7226
jvanrhyn@deloitte.com.au

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