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Tax Insights

Exposure draft on new debt deduction rules

Snapshot

During the 2022 election campaign, the ALP proposed to change the existing asset based thin capitalisation rules to 30% of EBITDA (earnings before interest, taxes, depreciation and amortisation) based on the OECD recommended approach, for income years beginning **on or after 1 July 2023**. It was proposed to also maintain a modified group ratio rule and a modified arm's length test.

On 5 August 2022, Treasury released a consultation paper on aspects of the proposed changes titled *Multinational Tax Integrity and Tax Transparency*.

Further details emerged in the 2022-23 October Budget, at which time it became clear that the modified arm's length test was going to be based on third party debt concepts.

On 16 March 2023, Treasury issued the Exposure Draft on the EBITDA interest limitation rules, (Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation). Consultation closes on 13 April 2023.

Overall, the Exposure Draft (ED) reflects the announced policy, however:

- There is significant tightening of many aspects of the rules compared to current law, which is likely to make many aspects unworkable for many taxpayers and lead to unexpected and capricious outcomes; and
- Proposed amendments to sections 25-90 and 230-15 to deny debt deductions related to the derivation of non-assessable non-exempt foreign non-portfolio dividends are an unexpected and unwelcome change that will be highly problematic for Australian based multinationals.

This Tax Insights provides initial observations on the key features of the proposed rules.

Start date

As per previous announcements, the amendments apply for **years of income commencing on or after 1 July 2023**. There is no deferred start date, no transitional provisions and no grandfathering. All aspects commence in approximately 100 days, leaving little time for effective consultation and responses thereto, assessing the impacts and planning appropriate responses as well as navigating the Parliamentary process and Royal Assent.

Denial of tax deductions: Division 768-A income

An unexpected shock emerged in the first item of the ED. It is proposed that Section 25-90 and section 230-15 be amended to no longer provide a deduction for interest costs relevantly connected with the derivation of non-assessable non-exempt (NANE) dividend income from foreign subsidiaries (per section 768-5). This had not been foreshadowed and the changes to sections 25-90 and 230-15 will apply to a wide range of taxpayers. For Australian-based multinationals, such interest would be wholly denied even before going to the thin capitalisation rules.

As background, the Labor Government previously announced a repeal of section 25-90 in 2013 (David Bradbury, Assistant Treasurer, 14 May 2013, here). Later that year following the election of the Abbott Government, it was decided not to proceed “because the revenue is essentially unrealisable and it would impose unreasonable compliance costs on Australian businesses” (refer here).

The proposed removal of tax deductibility will in particular affect Australian outbound groups, create significant practical retrospective tracing difficulties (to what extent is existing debt relevantly related or not related to offshore investments) and is inconsistent with the approach taken by the OECD in the Action 4 BEPS Report. It is expected that there will be strong arguments raised against this proposed change in the course of consultation.

New thin capitalisation framework

Taxpayers in scope

The current thin capitalisation measures broadly apply to:

- Australian entities that operate internationally (‘outward investor (general)’)
- Australian entities that are foreign controlled (‘inward investment vehicle (general)’)
- foreign entities that operate in Australia (‘inward investor (general)’)

The new ED introduces a **general class investor** concept which represents a consolidation of those existing ‘general’ classes of entities.

Exemptions

Where total debt deductions of an entity and associates are $2 million or less (de minimis threshold), the exclusion from the thin capitalisation rules continues.

Certain outward investing entities are currently excluded from the thin capitalisation rules where the Australian assets represent 90% or more of the total assets. With the introduction of the new general class investor concept, this provision is amended to ensure it continues to apply to outward investing entities and general class investors who, assuming they were financial entities, would be an outward investing financial entity (non-ADI).

Changes to definition of debt deduction

The definition of 'debt deduction' in section 820-40 of the ITAA 1997 is amended with the intention to capture interest and amounts economically equivalent to interest, in line with the OECD best practice guidance. In particular, the definition is amended to ensure that a cost incurred by an entity does not need to be incurred in relation to a debt interest issued by the entity for that cost to be a debt deduction. This change means that amounts which are economically equivalent to interest, but which may not necessarily be incurred in relation to a debt interest issued by the entity, fall within the definition of debt deductions.

Three new tests

The ED introduces new earnings-based tests for general class investors, specifically:

- The fixed ratio test (FRT), being 30% of tax EBITDA
- The group ratio test (GRT)
- The external third party debt test (ETPDT). This test is also available to financial entities that are not ADIs.

Financial entities and ADIs will otherwise continue to be subject to the existing asset-based thin capitalisation safe harbour and worldwide gearing tests.

The ED repeals paragraph (a) of the definition of 'financial entity' in subsection 995-1(1) of the ITAA 1997, thus significantly limiting the range of entities that can access the financial entity provisions. The repeal of paragraph (a) is expressed to be an integrity measure to ensure the thin capitalisation rules are fit for purpose and that the amendments to introduce the new earnings-based rules are not undermined. This change could be problematic for entities with financing businesses that do not fall into one of the limited remaining categories of "financial entities".

Choosing which test to apply

The **FRT is the default test for general class investors** that do not make a choice to use either the GRT or the ETPDT.

A choice for an income year to use either the GRT or the ETPDT must be made:

- In the approved form; and
- On or before the earlier of the day the entity lodges its income tax return for the income year and the day the entity is required to lodge its income tax return for the income year.

A choice for an income year cannot be revoked.

This represents a significant reduction in the flexibility of the rules, which currently provide that a taxpayer's thin capitalisation limit is the "highest" of the amounts calculated under the various tests. Further, if a taxpayer makes an error in their calculations or if there is a dispute with the ATO about the applicability of the test, the inability to switch to an alternative method could have significant adverse implications.

For example, if a taxpayer elects to rely on the ETPDT and it is subsequently determined that the relevant debt does not satisfy the third party conditions, or the taxpayer has an associate that has failed to elect for ETPDT, the taxpayer could be denied all debt deductions as it would not be able to access the FRT.

Fixed ratio test (FRT)

Definition of tax EBITDA

The fixed ratio test allows an entity to claim net debt deductions **up to 30 per cent of its tax EBITDA**. An entity's **tax EBITDA** for an income year is worked out according to the following steps:

- Step 1: Work out the entity's taxable income or tax loss for the income year (disregarding the operation of the thin capitalisation rules and treating a tax loss as a negative amount). This step effectively assumes that no debt deductions are denied by Division 820.
- Step 2: Add the entity's 'net debt deductions' for the income year.
- Step 3: Add the sum of the entity's decline in value and capital works deductions (if any) for the income year, under Subdivision 40-B and Division 43.
- Step 4: Add the sum of each of the entity's deductions for tax losses from earlier income years. Subject to Step 5, the result of Step 4 is the entity's tax EBITDA for the income year.
- Step 5: If the result of Step 4 is less than zero, it is treated as being zero.

The entity's **fixed ratio earnings limit** is 30% of tax EBITDA. Where the net debt deductions exceed the fixed ratio earnings limit, the **excess is disallowed**.

FRT disallowed amount

Current year disallowed deductions will be aggregated as **FRT disallowed amounts**, available for 15 year carry forward and potential utilisation.

Where in a subsequent year, the fixed ratio earnings limit **exceeds** the net debt deductions, prior year FRT disallowed amounts can be deducted in the current year as a **special deduction** up to the amount of that excess. The ability to utilise these FRT disallowed amounts is subject to a range of conditions including:

- The carry forward of such FRT disallowed amounts will terminate if in a particular year, the taxpayer adopts either the GRT or the ETPDT. That is, the utilisation of FRT disallowed amounts effectively precludes the adoption of the alternative methods.
- If an entity is a company, the company must pass a modified version of the continuity of ownership test (COT) in relation to each of their FRT disallowed amounts they are seeking to apply.

Other matters

- No modified rules apply for public benefit (infrastructure) projects.
- Under the FRT test, there is no ability to group entities or share attributes, outside of tax consolidation. This effectively penalises non-consolidated and non-corporate structures with debt deductions in one entity and related earnings in another entity.
- The inability to take into account associate entity fixed ratio "excess amounts" (i.e. excess capacity under the fixed ratio test) is particularly relevant to unit trusts, which are unable to form a tax consolidated group
- Tax EBITDA ignores the application of carry forward capital losses or capital allowances outside Subdivision 40-B or Division 43 (for example blackhole or project pool deductions).

Group ratio test (GRT)

A general class investor can choose to use the GRT if it is a member of a **GR group** and the GR group EBTIDA for the period is not less than zero.

The GRT can be used as an alternative to the FRT for more highly leveraged groups. The GRT allows an entity in a group to deduct net debt deductions in excess of the amount permitted under the FRT, based on a relevant financial data for the worldwide group.

- A 'GR group', for a period, is the group comprised of the relevant worldwide parent entity and, generally, all other entities in the group.
- The worldwide parent entity is referred to as the 'GR group parent' and must have financial statements that are audited consolidated financial statements for the period.

- Each entity that is fully consolidated on a line-by-line basis in the GR group parent's audited consolidated financial statements is referred to as a 'GR group member'

The GRT requires an entity to determine an **entity's group ratio** for an income year according to the following steps:

- Step 1: Work out the **GR group net third party interest expense** of the GR group based on financial statements.
- Step 2: Work out the **GR group EBITDA** of the GR group based on financial statements.
- Step 3: Divide the result of Step 1 by the result of Step 2. Subject to Step 4, the result of Step 3 is the **entity's group ratio** for the income year.
- Step 4: If the result of Step 2 is zero or less, the entity's group ratio for the income year is zero.

An **entity's group ratio earnings limit** for an income year is the entity's group ratio for the income year multiplied by its tax EBITDA for the income year.

Net debt deductions are allowed up to the **entity's group ratio earnings limit** for the income year. Excess net debt deductions over the entity's group ratio earnings limit are **disallowed**.

There are a number of problematic aspects to these GRT rules, including:

- In calculating GR group EBITDA, it is necessary to exclude from the calculation any entities in the group which have negative EBITDA. For large multinational groups, this requirement is likely to be extremely burdensome.
- In certain circumstances, taxpayers will be required to make adjustments to the amounts disclosed in the audited consolidated financial statements to include amounts akin to interest and to disregard certain payments to associate entities. Again, for large multinational groups, such adjustments are likely to make the test impractical to apply.

Entities are required to prepare and keep records of how they worked out their group ratio. The records must contain the particulars that have been taken into account in working out the group ratio and must be sufficient for a reasonable person to understand how the group ratio has been calculated. The entity must prepare the records by the time the entity is due to lodge its income tax return for the income year.

External third-party debt test (ETPDT)

The ED explanatory memorandum states that the ETPDT is designed specifically to be narrow, to accommodate only genuine commercial debt arrangements relating only to Australian operations and investments.

General class investors can choose to apply the ETPDT in relation to an income year. However, general class investors cannot make this choice if:

- The entity has one or more associate entities who are general class investors for the income year; and
- Those associate entities are not exempt from the thin capitalisation rules; and
- At least one of the associate entities does not make a choice to use the external third party debt test.

The restriction effectively requires a general class investor and all of its associate entities to make a consistent choice to use the ETPDT, if any one of those entities wishes to use that test. This will be an important change for some industries such as infrastructure.

A modified definition of 'associate entity' applies for the purposes of the restriction and is based on a **thin capitalisation control interest of 10% or more**. This low-percentage control interest makes the identification of all relevant associate entities a difficult exercise, and in any event, it may be that not all of those parties wish to adopt the ETPDT, which would preclude any of the associate entities from accessing the ETPDT.

An entity's **external third party earnings limit** for an income year is the sum of each debt deduction of the entity for the income year that is attributable to a debt interest issued by the entity that satisfies the **external third-party debt conditions** in relation to the income year.

A debt interest issued by an entity satisfies the 'external third-party debt conditions' in relation to an income year if the following conditions are satisfied:

- The entity issued the debt interest to an entity that is not an associate entity of the entity;
- The debt interest is not held at any time in the income year by an entity that is an associate entity of the entity;
- The holder of the debt interest has recourse for payment of the debt **only** to the assets of the entity; and
- The entity uses the proceeds of issuing the debt interest **wholly** to fund:
  - Its investments that relate only to assets that are attributable to the entity's Australian permanent establishments or that the entity holds for the purposes of producing assessable income; and
  - Its Australian operations.

Third party lenders often require a broad range of security, including security over the equity in the borrower or direct security over assets of subsidiaries of the borrower, which may make the ETPDT difficult to access in practice.

Additional rules allow on-lending via **conduit financer** arrangements to satisfy the external third party where:

- A conduit financier borrows an amount from an ultimate lender under an arrangement that satisfies the external third-party debt conditions (other than in respect of recourse)
- The conduit financier **on-lends the amount to one or more** associate entities (the borrowers) **on the same terms** (other than amount)
- The ultimate lender has recourse **only** to the assets of each borrower and each asset of the conduit financier that is a loan to a borrower.

There is no further guidance in relation to the requirement that the on-lending is on the same terms, and on a strict reading, this requirement would be very difficult to satisfy if it requires the loan from the conduit financier to the borrower to be the same terms as the loan from the ultimate lender, including providing the same security.

Loans between stapled entities (that are not associate entities) would appear not eligible to access the conduit financier rules. Stapled structures are commonly used in the property and infrastructure sectors.

Moreover, the conduit financier rules cannot apply where an overseas group entity borrows from a third party and on-lends to an Australian associate entity, even if the on-lending is on the same terms.

The narrow way in which the external third-party debt conditions have been defined means that this test will only be available to a small number of general class investors. Any third party debt arrangements involving parental guarantees, other guarantees provided by associates, or multi-borrower syndicated facilities, which are common commercial debt arrangements, will not be eligible for the ETPDT.

Moreover, the test further reinforces the need for tracing and in practice it may be very difficult or impossible for Australian multinationals to prove that debt has been used "wholly" to fund Australian operations.

Interaction with the transfer pricing rules

The application of the existing transfer pricing rules to arrangements involving debt deductions is limited by section 815-140, whereby the transfer pricing rules cannot apply to adjust the quantum of debt. The transfer pricing rules can therefore only adjust the interest rate, preserving the role of the existing thin capitalisation rules in regards to an entity's level of debt.

Since the new earnings-based tests do not determine a maximum allowable debt amount, this limitation on the transfer pricing rules will be removed for entities that are using these tests. As a result, the scope of the transfer pricing rules for these entities will be extended to apply to **both** the quantum of debt and the interest rate.

Practically this means that the transfer pricing rules operate prior to the EBITDA based interest limitation rules. This is a significant change and will require general class investors to self-assess and document whether their quantum of debt is consistent with arm's length conditions, irrespective of whether their debt deductions fall within the EBITDA based interest limit.

Restructuring in response to the new rules

Conceptually, the thin capitalisation rules – both current and proposed – set a borderline between what is accepted as a tax deductible amount of interest expense and an excessive amount of interest expense, with the policy objective that taxpayers should base their debt settings so as to fall into the permitted zone. Necessarily, when the regime shifts from the current asset based tests to earnings based tests, arrangements that are currently within the permitted zone may cease to be within that zone, and vice versa.

It is to be expected that taxpayers will look at restructuring their affairs to take into account the permitted zone under the new laws. Does that of itself create avoidance risks?

When the hybrid mismatch rules were introduced, the ATO issued PCG 2018/7: Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements. The ATO acknowledged that a likely response would be for affected taxpayers to restructure out of their existing arrangements to avoid any potential adverse impact of the new rules. The PCG identified low risk restructurings which were consistent with the underlying objective of the new rules.

Similar guidance will be needed promptly to provide guidance to taxpayers on transitioning into the new laws without creating additional tax risks.

Next steps

Treasury is seeking submissions on:

- The ED and ED explanatory material generally
- Whether the legislation operates with sufficient integrity, in line with the OECD's best practice guidance
- Priority issues that would inform the ATO's administrative approach and public advice and guidance on this measure.

Consultation closes on 13 April 2023.

It is hoped that there will be meaningful consideration of the submission responses with some modifications to make the provisions more workable, whilst still being consistent with the policy objective.

Taxpayers now finally have an understanding of the broad shape of the proposed new regime, and can begin to better assess the impacts of the proposed measures.

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