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9 April 2024

Australia 2024/05

Tax Insights

New interest limitation rules finally passed: operative from 1 July 2023

Snapshot

On 8 April 2024, the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Bill 2023 (**Multinational Tax Bill** or **Bill**) which introduces the new **interest limitation rules** received Royal Assent.

We arrive at this point more than a year since the Government formally announced its intention to introduce new interest limitation rules to replace the thin capitalisation regime, and nine months after the general commencement date for the new rules. The Bill was subject to two Senate reviews, lengthy consultation, and significant shifts on key policy and design matters as it progressed from Exposure Draft (March 2023) to Bill stage (June 2023) to final passage including material Government amendments. The process and the outcome was less than optimal, if only by virtue of the law being finalised so long after commencement.

Broadly, the new regime applies to **general class investors** and is operative for years of income starting on or after **1 July 2023**, whilst the new "debt deduction creation rules" (**DDCR** or **debt creation rules**) will be first operative for years of income starting on or after **1 July 2024.**

The Multinational Tax Bill also dealt with "Multinational tax transparency - disclosure of subsidiaries" (schedule 1): this publication only deals with the interest limitation rules in schedule 2.

Senate amendments agreed to on 27 March 2024

The Multinational Tax Bill was debated in the Senate on 26 March 2024. Significant Senate amendments were put by the Government, Greens, Coalition and Sen David Pocock. Due to time constraints, the debate was cut short and the amendments were put to a vote with no further debate. After passing the Senate, the Bill briefly returned to the House of Representatives on 27 March 2024, where it was passed.

The following Senate amendments were agreed to:

- The Government amendments, first circulated in November 2023, were passed in the form as initially released by the Government, subject to a minor change relating to the calculation of tax EBITDA in relation to native forests.
- A post implementation review is to occur pursuant to a Senator David Pocock amendment.
- Pursuant to a Senator Hanson amendment, the old law (as at 30 June 2023) continues to apply to Australian plantation forestry entities.

The post implementation review requires that:

- An independent review be conducted of the operation of the new interest limitation rules;
- The review commences no later than 1 February 2026 and allows for public consultation;
- A written report of the review be provided to the Minister within 17 months of the commencement of the review; and
- The report be tabled in each House of Parliament within 15 sitting days after receiving the report.

ATO advice and guidance

The Australian Taxation Office (ATO) have commenced consulting on public advice and guidance needed in relation to the new measures. During a Senate Committee public hearing in January 2024, the ATO stated it will be "progressing products that address both priority areas of interpretation and also practical compliance approaches", particularly around the transition. The ATO stated that "taxpayers and stakeholders are particularly keen to know about the transitional arrangements".[1] The ATO made further comments on applying integrity rules:

> "…as a general principle, the ATO would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law".[2]

Commencement dates

The new interest limitation rules will apply to **income years starting on or after 1 July 2023**. That is, the new rules are already operative for companies with a 30 June year end and will commence from 1 January 2024 for December year ends.

A one-year **delayed** start date applies for the **debt creation rules** which will apply to income years starting **on or after 1 July 2024**.

[1] Evidence to Senate Economics Legislation Committee, Parliament of Australia, Canberra, 31 January 2024, 18 (Mr Ben Kelly, Deputy Commissioner, Policy, Analysis and Legislation, Australian Taxation Office).
[2]Ibid

As mentioned above, pursuant to a Senator Hanson amendment, the old law (as at 30 June 2023) continues to apply to Australian plantation forestry entities.

Status of section 25-90

A significant surprise in the March 2023 Exposure Draft on this measure was the amendment of sections 25-90 and 230-15 to effectively deny a tax deduction for interest costs relevantly connected with the derivation of non-assessable non-exempt (**NANE**) dividend income from foreign affiliates.

This was removed from the Multinational Tax Bill when introduced in June 2023, following widespread stakeholder concerns. The Government stated that the proposed amendment had been "deferred", and that there will be a further consultation process on this issue. There have been no further announcements to date.

Interest limitation rules: overview

In broad terms, the new rules will align the Australian interest limitation rules to OECD best practice based on tax EBITDA, in place of the longstanding asset-based pre-1 July 2023 thin capitalisation rules.

Taxpayers in scope

The new rules apply to a **general class investor**, which is a new concept which represents a consolidation of pre-1 July 2023 'general' classes of entities, being:

- Australian entities investing overseas, previously referred to as 'outward investing entities (general);
- Australian entities that are, either directly or indirectly, foreign controlled, previously referred to as inward investment vehicles (general); and
- Foreign entities investing in Australia, previously referred to as inward investors (general).

A general class investor does not include a financial entity or an ADI.

Three tests

There are three potential tests available to general class investors, being the:

- Fixed Ratio Test (**FRT**), the default test based on 30% of tax EBITDA;
- Group Ratio Test (**GRT**); and
- Third Party Debt Test (**TPDT**). This test is also available to financial entities that are not ADIs in place of the arm's length debt test.

Financial entities and ADIs will otherwise continue to be subject to the existing asset-based thin capitalisation safe harbour and worldwide gearing tests. The bill repeals paragraph (a) of the definition of 'financial entity' in subsection 995-1(1) of the ITAA 1997, thus limiting the range of entities that can access the financial entity provisions.

Exemptions

Where total debt deductions of an entity and associates are $2 million or less (de minimis threshold), the carve-out from the interest limitation rules continues.

Certain outward investing entities were excluded from the pre-1 July 2023 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).

Expanded definition of debt deduction

The FRT and the GRT apply to potentially reduce 'net debt deductions'. 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 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.

The expanded scope of debt deduction is likely to result in amounts not previously considered to be a debt deduction (under the pre-1 July 2023 rules) being in scope of the post 1 July 2023 interest limitation rules. It is intended that interest related costs under swaps, such as interest rate swaps, are included in the widened definition of debt deduction.

Interaction with transfer pricing

Under the pre-1 July 2023 thin capitalisation rules, the operation of the transfer pricing provisions was, in broad terms, limited to being able to adjust the rate of interest but not the quantum of debt. This will change under the new rules, with the result that both the interest rate and the debt quantum could be modified by the transfer pricing provisions.

If an amount of interest is treated as non-deductible under the transfer pricing provisions, it is excluded from the definition of debt deduction, and effectively excluded from the operation of the new interest limitation rules.

This reflects that whilst the default position under the pre-1 July 2023 rules operated as a 'safe harbour' in relation to the amount of debt, the new interest limitation rules do not provide a safe harbour, but only prescribe a maximum amount of interest expense.

Interaction with debt creation

In respect of the FRT and the GRT, the debt creation rules take priority over the general operation of the new interest limitation rules. That is, if a debt deduction is within scope of the broad operation of the debt creation rules, the amount is denied (in whole or in part) by those rules. To the extent that the debt deduction is so denied, it does not get further taken into account for the purposes of the FRT and the GRT.

Choice of test and ordering

The **FRT is the default test for general class investors** that do not make a choice to use the GRT or TPDT or are not deemed to apply the TPDT.

Where an entity makes a choice for an income year to use the GRT or the TPDT, it 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 year and the day the entity is required to lodge its income tax return for the year. The Commissioner has a discretion to allow the choice to be made by a later day.

There is a limited ability for the Commissioner to allow a taxpayer to revoke such a choice within four years where it is "fair and reasonable".

Associate entities may be deemed to apply the TPDT.

Fixed Ratio Test (FRT)

By way of introduction, if net debt deductions for a year are less than **30% of tax EBITDA** for that year, the whole of the interest expense is allowed as a deduction. If net debt deductions exceed 30% of tax EBITDA, the excess amount is denied as a current year deduction. As profitability and hence EBITDA is relatively volatile as compared to an asset-based test under the pre-1 July 2023 thin capitalisation rules, there is the prospect that interest deductions may be denied in a particular year as a result of such volatility. Accordingly, there is the ability to carry forward denied interest deductions under the FRT.

Definition of 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 subject to the following:

    a) Disregard the operation of the interest limitation rules apart from the DDCR;

    b) Prior year tax losses are to be deducted in computing the entity's taxable income. This can include tax losses incurred **prior to** the commencement of the new interest limitation rules. A corporate tax entity is required to **assume** that it chooses to deduct all the entity's tax losses that have been carried forward from prior years;

    c) Dividends, share of trust income and share of partnership income or loss are included in the taxable income amount in the normal way where the shareholder, beneficiary or partner has a non-associate interest (broadly, less than 10%);

    d) If the entity is a shareholder in a company, and is an associate entity[3] of the company, **disregard** any dividend or non-share dividend paid by the company to the entity included in the entity's assessable income. Similarly, **disregard** amounts included in the entity's assessable income that relate to income as a partner or beneficiary of a trust (other than an AMIT) where the partner / beneficiary is an associate entity of the partnership or trust;

    e) **Disregard** any amounts that are included in assessable income due to Division 207 (gross-up for franking credits);

    f) In working out the taxable income or taxable loss, **subtract** an amount equivalent to any notional deduction the entity is entitled to under Division 355 in relation to R & D activities of the R & D entity;

    g) Treat a tax loss as a negative amount.

- Step 2: Add the entity's **net debt deductions** for the income year;

- Step 3: Add the sum of the entity's deductions (if any) from its assessable income for the income year that are any of the following:

    - The entity's **decline in value and capital works deductions** (if any) for the income year, under **Divisions 40 and 43** (other than deductions for the entire amount of an expense incurred by the entity);

    - General deductions that relate to forestry establishment and preparation costs, capital costs of acquiring trees (unless those costs relate to the clearing of native forests);

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[3] TC control interest of 10% or more

- Step 4: Add the **excess tax EBITDA amount** (if any); and
- Step 5: Any further adjustments as required by Regulation.

If the result if the above steps is less than zero, the tax EBITDA amount is taken to be zero.

Fixed ratio earnings limit

The entity's **fixed ratio earnings limit** is 30% of tax EBITDA:

- Where the net debt deductions are **less than** the fixed ratio earnings limit, no amount of debt deductions is disallowed.
- Where the net debt deductions **exceed** the fixed ratio earnings limit, the excess is disallowed in that year.

Carry forward of FRT disallowed amounts

Current year disallowed deductions will be treated as **FRT disallowed amounts**, available for 15 year carry forward and potential utilisation. Where in a subsequent year, the fixed ratio earnings limit (30% of tax EBITDA) **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.

If however, an entity has excess capacity in a current year (the fixed ratio earnings limit (30% of tax EBITDA) exceeds the net debt deductions) and does not have any FRT disallowed amounts, the excess capacity attribute cannot be used in any year.

If an entity is a company or a trust, the entity must pass a modified version of the company or trust loss rules in order to continue to carry forward the FRT disallowed amounts. If an entity used the FRT in an income year and chooses another test in a subsequent income year, the entity loses the ability to carry forward any existing FRT disallowed amounts.

Impact of tax losses

Where an entity has prior year tax losses (including tax losses that relate to years ending prior to 1 July 2023), those tax losses will reduce the taxable income amount determined as the first step of the tax EBITDA calculation. The result of this is that interest expense in later years is more likely to exceed the fixed ratio earnings limit (30% of tax EBITDA). As a result, such interest deductions are more likely to be denied in the recoupment year and added to the balance of FRT disallowed amounts. In other words, the interest deduction is deferred, and only available if the carry forward conditions for FRT disallowed amounts are met on an ongoing basis. This can be viewed as converting what may otherwise be carry forward tax losses to 15 year limited FRT disallowed amounts.

Excess tax EBITDA amount

The Government amendments introduce a concept of "**excess tax EBITDA amounts**" where the FRT is applied. In broad terms, the excess tax EBITDA amount of an entity is the excess of the fixed ratio earnings limit (30% of tax EBITDA) over the sum of net debt deductions and carry forward FRT disallowed amounts. Where applicable, this provision permits eligible controlled entities to transfer excess tax EBITDA amounts to eligible controlling entities, based on the level of ownership.

This is relevant in the context of where a general class investor which is a controlling entity has debt deductions, whilst the relevant operations, business income and business deductions arise in a general class investor controlled entity. This effectively allows a proportionate "matching" of any unused tax EBITDA capacity in a controlled entity with the interest expense in the controlling entity(s).

The provision covers cases where the controlling entity and the controlled entity is any combination of:

- A company that is an Australian entity;
- A unit trust that is a resident trust for CGT purposes; and
- A managed investment trust or a partnership that is an Australian entity (requiring that Australian residents have a relevant partnership interest of 50% or more).

Further, the controlling entity must have a **relevant control interest of 50% or more** in the controlled entity (with the excess tax EBITDA amount being reduced for any days in an income year where that threshold is not met).

Group Ratio Test (GRT)

Overview

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 30% of tax EBITDA, based on 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 GR group members;
- 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; and
- 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 (if the result at this step is zero or less, the entity's group ratio is zero).
- Step 3: Divide the result of Step 1 by the result of Step 2. The result of Step 3 is the **entity's group ratio** for the income year.

The **GR group EBITDA** is the sum of the GR group's:

- Net profit (disregarding interest expense);
- Adjusted net third party interest expenses; and
- Depreciation and amortisation expenses.

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.

Deloitte comments

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.

Third Party Debt Test

A general class investor or financial investor (non ADI) that is an Australian entity can choose to apply the TPDT for an income year.

An entity that satisfies all of the following requirements will also be deemed to make the TPDT for that income year:

- The entity is a member of the same tax obligor group as the entity that issued the debt interest (the *borrower entity*) in relation to that debt interest;
- The borrower entity has made the choice;
- The entity is an associate entity of the borrower entity; and
- Both the entity and the borrower entity are required to lodge an Australian income tax return for the year.

An entity is a member of the borrower entity's tax obligor group if the creditor has recourse for payment of the debt to assets of the entity (disregarding assets of the entity that are membership interests in the borrower entity).

In addition, the deeming will extend to any entity that is a party to a cross staple arrangement with an entity that has made the choice or is deemed to have made the choice.

Where a debt interest satisfies the requirements of the TPDT all the debt deductions attributable to that debt interest should be deductible based on the third party earnings limit for that year. This should include debt deductions directly associated with hedging or managing interest rate risk (other than amounts paid to associate entities). Conversely, all debt deductions attributable to debt interests that do **not** meet the requirements of the TPDT will be **non-deductible**.

Two tests

The TPDT comprises a **base test** for third party debt provided directly to the borrower as well as a conduit financing test for third party debt provided to a conduit financier that is subsequently on-lent to associate entities within the tax obligor group.

'Australian entity' condition

Under the base test, the borrower must be an "Australian entity". An Australian entity for these purposes includes an Australian resident, an Australian trust or a partnership in which one or more Australian residents or Australian trusts hold a direct participation interest of at least 50%.

Permitted recourse and credit support prohibition

The scope of permitted recourse and the credit support prohibition was among the most confusing and contentious aspects of the TPDT in the Bill as introduced. This was because the requirements were considered incompatible with standard M&A and asset or project financing arrangements – particularly those which involved multiple non tax consolidated entities.

The Government amendments retain the significantly improved permitted recourse test included on the October ED by allowing the external lender recourse to the following assets under both the base test and the conduit financing test:

- The Australian assets of the borrower;
- Membership interests in the borrower (except where the borrower holds a direct or indirect interest in non Australian assets); and
- The Australian assets of the tax obligor group.

The drafting has been further improved by allowing recourse to minor or insignificant ineligible assets. The EM (unhelpfully) states that determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature. It remains to be seen how broadly such a provision will be interpreted.

The October ED drafting was still problematic in that any recourse to an asset that constituted rights under or in relation to a guarantee, security or other form of credit support was prohibited, subject to satisfying a very limited carve out for developments involving the ownership or leasing of land. This meant that cross-collateralisation, equity commitment deeds, letters of credit and performance bonds provided to the borrower (even by non associated entities and members of the same tax obligor group) provided in many typical infrastructure projects appeared to breach the TPDT requirements with similar issues arising for investments or development of real estate.

The Government amendments substantially address these remaining concerns by expanding the carve out from prohibited credit support by allowing a guarantee, security or other credit support to be disregarded where it is any of the following (except where it provides recourse directly or indirectly against a foreign associated entity):

- A right that provides recourse, directly or indirectly, only to one or more Australian assets (other than another credit support right that is not disregarded) that satisfy the recourse requirements;
- A right that is provided by non associated entities (e.g., performance bonds provided by an unrelated builder or a parent guarantee provided by an unrelated lessee);
- A right that relates wholly to the development of land situated in Australia (including an interest in land) or moveable property that is relevant to the use of the land and will remain on the land for the majority of its useful life (e.g. a renewable energy generating asset that is moveable property situated on Australian land as outlined in the EM); or
- A right that relates wholly to the development of offshore renewable energy infrastructure (within the meaning of the Offshore Electricity Infrastructure Act 2021) situated in a declared area (including directly related infrastructure of that kind).

Deloitte comments

- The substantial changes made to permitted recourse and credit support requirements in the TPDT are very welcome and will significantly improve the compatibility of the test with typical M&A and asset or project financing arrangements.
- A further extension of the development phase carve out to credit support provided directly or indirectly by foreign associate entities would have further addressed industry concerns around permitted recourse. It is submitted that such a limited carve out should be acceptable from a policy perspective particularly as Australia looks to fund its growing housing and infrastructure requirements.

Debt Creation Rules

Objective

The objective of the new DDCR (as per the Explanatory Memorandum) is to disallow debt deductions to the extent that they are incurred "in relation to debt creation schemes that lack genuine commercial justification". We note that there is no such test in the legislation.

Instead, the new Subdivision 820-EAA is drafted very mechanically and broadly and is likely to deny debt deductions in a wide variety of ordinary circumstances which would not normally be considered a debt creation scheme.

Commencement

The DDCR apply to income years beginning on or after 1 July 2024. The debt creation provisions can apply to arrangements entered into prior to that date (and indeed potentially many years ago) where an in-scope debt deduction arises after the commencement date.

Application

Broadly, the debt creation rules only apply to entities that are subject to the thin capitalisation rules (general class investors, outward investing financial entities (non-ADI) and inward investing financial entities (non-ADI)).

The DDCR provisions do not apply to:

- Entities exempted under section 820-35 where the debt deductions of that entity and all its associates for that year are $2 million or less;
- Certain special purpose entities (under section 820-39), and
- ADIs and securitisation vehicles.

Entities which are excluded from the thin capitalisation provisions because they satisfy the 90 per cent Australian assets rule under section 820-37 will be subject to the DDCR rules.

Ordering rule

The debt creation rule has priority in the application of Division 820. To the extent debt deductions are disallowed under these rules, the deductions are disregarded for the purposes of applying the interest limitation rules.

However, the debt creation rules do not apply where the taxpayer has made a choice (or is taken to have chosen) to use the TPDT.

Application to "associate pairs"

For the provisions to apply, the relevant entity's debt deduction must be paid or payable, directly or indirectly, to a relevant associate pair. An entity is an associate pair of another **entity if any of the following conditions are satisfied:**

1. The entity is an associate of the other entity; and
2. The other entity is an associate of the entity.

The provisions provide for a modified meaning of associate pair in respect of unit trusts, treating the trust as if it were a company. A modified meaning of Australian entity for partnerships has also been proposed.

For simplicity, the terms associate, associate pair and related party are used interchangeably in this publication, although the relevant technical term is typically 'associate pair'.

Two main rules

The debt creation rules disallow interest deductions relevantly connected with two broad scenarios:

1. Acquisitions of assets (or obligations) from associates (subsection 820-423A(2)), and
2. Certain prescribed payments or distributions to associates (subsection 820-423A(5)).

It is noted that both of these rules could apply even where the relevant interest income is derived by an Australian taxpayer and fully subject to Australian income tax.

1. Acquisitions of assets from associates

The first case broadly involves:

- An entity (or associate) incurs debt deductions referable to an amount due to a relevant associate; and
- The entity:
  - **Acquires a CGT asset**; or
  - **Acquires a legal or equitable obligation**

  (directly or indirectly) from a relevant associate; and
- The debt deductions are in relation to the **acquisition or holding** of that asset or obligation.

There are **three exceptions** to this first case:

- The acquisition of a new membership interest in an Australian entity or a foreign company;
- The acquisition of certain new tangible depreciating assets to be used for a taxable purpose in Australia within 12 months; and
- The acquisition of certain debt interests issued by an associate pair of the acquirer.

Whilst the scope of the rules is relatively clear in connection with the acquisition of a CGT asset, the operation with respect to the acquisition of a legal or equitable obligation is less clear.

The debt deductions are disallowed **to the extent** that they are incurred in relation to the **acquisition**, or **subsequent holding**, of the asset or obligation.

2. Payments or distributions to associates

The second case broadly involves:

- An entity (associate pair payer) obtains proceeds from a financial arrangement;
- The payer uses some or all of the proceeds from the related party debt to:
    - Fund, or
    - Facilitate the funding of;

  a prescribed payment or distribution to an associate pair recipient.

Prescribed payments or distributions include dividends and trust distributions, amounts of capital, such as returns of capital, royalties (and similar amounts), a payment or distribution that is "of a kind similar" to listed payments or distributions and a payment or distribution prescribed in a Regulation.

The rules do not affect the deductibility or otherwise of the payment or distribution, but rather disallows the relevantly connected debt deductions on the funding of the payment or distribution.

Further, certain repayments of principal will also be a prescribed payment. For example, if (broadly) interest deductions on an existing related party loan were disallowed, and the existing loan was refinanced with a related party loan, the interest deductions on the new loan would also be disallowed by the debt creation rules. Alternatively, if the existing related party loan was refinanced with unrelated debt, the interest deductions on the new loan should not be disallowed by the debt creation rules.

If interest deductions on an existing related party loan are not disallowed by the debt creation rules (such as where the funds were used to acquire an asset from or make a payment to an unrelated party), and the existing loan was refinanced with a new loan, whether from a related or unrelated party, the interest deductions on the new loan should not be disallowed by the debt creation rules.

Debt deductions are disallowed on a proportionate basis, to the extent that the relevant entity incurred the debt deduction in relation to an in-scope acquisition, payment or distribution.

Debt deduction creation anti-avoidance rule

The Commissioner has been given a very broad power to treat an arrangement that does not fall within the scope of the debt creation rules as if the debt creation rules apply to such an arrangement if the Commissioner is satisfied that a principal purpose of a scheme was to avoid the application of the debt creation rules. There are no specified matters that the Commissioner has to consider in connection with this provision.

The Supplementary Explanatory Memorandum issued with the Government amendments states as follows:

- "1.44 The anti-avoidance rules in section 820-423D may also apply to any avoidance schemes relating to the debt deduction creation rules. However, these rules are **not intended to apply to schemes where a taxpayer is merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules**. The application of section 820-423D will ultimately depend on the facts and circumstances of each case" (emphasis added).

The EM language is helpful, and consistent with a sensible approach that policy-compliant restructures should be encouraged.

The anti-avoidance rules under Part IVA may also apply to any avoidance schemes relating to the debt creation rules.

Deloitte observations

The new interest limitation rules will pose a range of challenges to different taxpayer segments and will generally require a detailed and considered response. Some of the expected issues are noted below:

- For those taxpayers adopting the FRT, the key issue will be anticipating and managing potential volatility in earnings, and then managing utilisation of the FRT disallowed amount;
- Under the FRT, there will be cases where existing structures result in stranded interest deductions, for example, where an investor incurs interest expense in respect of an investment of 10% or more, but less than 50%. The implications of such arrangements will need to be reviewed, and if restructures are considered, the debt creation rules and other anti-avoidance measures will need to be considered;
- It is also expected that the scope of debt deductions under the revised definition will include a wider range of costs than had previously been included in the definition, with the consequence that the wider range of costs may be subject to denial under the FRT;
- It seems that many of the issues in connection with the TPDT have been addressed, although care will need to be taken that the specific requirements in respect of each potential eligible third party loan are satisfied. Further, taxpayers will need to be aware of situations where they may be deemed to make a TPDT choice, where that is not otherwise the optimal outcome.

However, before addressing any of the issues in respect of the FRT, GRT or TPDT, taxpayers need to address two critical threshold issues.

First, the transfer pricing rules can now operate both in respect of the interest rate and the quantum of debt. Interest expense denied under the transfer pricing rules is permanently non-deductible (that is, it is not a debt deduction and is not eligible for potential FRT disallowed amount carry forward).

Secondly, the debt creation rules will require consideration by any taxpayer with related party debt. The debt creation rules can deny debt deductions incurred in years starting on or after 1 July 2024, including in respect of arrangements entered into before that time (including arrangements entered into many years ago). The debt creation rules operate prior to the application of the FRT or the GRT (but do not apply if an entity has made a TPDT choice for that income year).

The two operative provisions in the debt creation rules include broad nexus tests as between debt deductions paid under a related party financing arrangement and in scope payments, being:

1. The acquisition and holding of a CGT asset or obligation acquired from a relevant associate; or
2. The use of such borrowings to fund or facilitate a prescribed payment such as a dividend, capital return or royalty. An indication of the scope of the debt creation rules is that debt deductions will be disallowed where it relates to related party borrowings used to fund the acquisition of trading stock from a related party.

Prior to commencement of the debt creation rules, taxpayers with existing related party financing arrangements will need to consider whether such arrangements can be relevantly linked to in-scope payments. Where this is the case, or is at risk of being the case, consideration will need to be given to appropriate restructurings, noting that this will likely also raise potential risks under the debt creation rules and / or under various anti-avoidance rules, including a new anti-avoidance rule embedded in the debt creation rules.

Further, the debt creation rules will need to be considered on an ongoing basis as new borrowings or refinancings are entered into, and as future in-scope payments are made.

Next steps

As we move towards year-end, for many, the first year of the new interest limitation rules comes to a close and the debt creation rules commence: taxpayers should consider the following actions, amongst others:

- Determine which interest limitation method will provide the optimal level of deductibility of debt deductions

  This may require modelling work to be done now, noting that there may also be an opportunity to utilise carried forward denied deductions (under the FRT) in the future where there is expected to be an increase in taxable income;

- For those taxpayers considering applying the GRT, there are some key questions. Do you have a qualifying GR Group? Will the audited consolidated financial statements be available for the group in time for filing? Do you have sufficient information to make the required adjustments?

- Do your existing loan, on-loan and hedging agreements satisfy the TPDT requirements? This may be particularly relevant for those taxpayers which have a group financing entity; and

- Are there are any related party debt arrangements to which the debt deduction creation rules could apply? What analysis needs to be done to determine this? What supporting evidence exists or needs to be located in relation to affected financing transactions entered into prior to 1 July 2024?

  If the debt deduction creation rules do apply, what needs to be done to address the risks now (i.e., prior to 1 July 2024)? What analysis, support and steps need to be taken (e.g., specific tracing, documentation, restructuring, capitalisation and so on).

Preparation is critical. This cannot be left to be done as part of the standard tax return process long after year end.

Contacts

Richard Lambkin
Partner
Tel: +61 3 3 9322 5788
rlambkin@deloitte.com.au

Sharon Murray
Partner
Tel: +61 3 9671 7939
sharmurray@deloitte.com.au

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

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

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

Max Persson
Partner
Tel: +61 2 9322 7538
mpersson@deloitte.com.au

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

Christopher Ferguson
Partner
Tel: +61 3 9671 8638
chrferguson@deloitte.com.au

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

Geoff Gill
Partner
Tel: +61 2 9322 5358
gegill@deloitte.com.au

Priscilla Ratilal
Partner
Tel: +61 2 9322 5086
pratilal@deloitte.com.au

Zubin Sadri
Partner
Tel: +61 3 9671 7063
zsadri@deloitte.com.au

9 April 2024

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