HALL CHADWICK

Thinner Capitalisation

Understanding Australia's New Thin Capitalisation Rules

Introduction

Since 1987, thin capitalisation rules have operated to limit the inclusion of certain deductions in Australian income tax returns for interest expenses incurred by certain taxpayers.

Generally speaking, the thin capitalisation rules target the following types of multinational entities:

- Australian entities with international operations (and some of their associates);
- Foreign-controlled Australian entities; and
- Foreign entities that operate in Australia.

In June 2023, the Australian Federal Government introduced draft legislation into the Federal Parliament in respect of important changes to the thin capitalisation rules in Australia that apply from 1 July 2023. Various amendments were made to the draft legislation between June 2023 and April 2024.

On 8 April 2024, the Treasury Laws Amendment (Making Multinationals Pay Their Fare Share – Integrity and Transparency) Bill 2023 (Cth) received Royal Assent and was passed by Federal Parliament.

The new legislation is designed to strengthen Australia's thin capitalisation rules. It is also intended to address '*risks to the domestic tax base arising from the excessive use of debt deductions, which amount to base erosion or profit shifting arrangements*'.[1]

The updated rules introduce a new earnings-based test to limit interest expenses or debt deductions in line with an entity's 'cash' profits.

The changes to the rules are consistent with the October 2015 OECD report "*Action 4 – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.*"

Prior to 1 July 2023, determinations of whether an entity fell into the thin capitalisation regime were based on balance sheet ratios, not earnings.

The new rules in Division 820-AA <u>will not</u> apply to financial entities and authorised deposit-taking institutions (**ADIs**).

This publication addresses:

1. Preliminary observations on the new thin capitalisation rules;
2. The new Fixed Ratio Test; and
3. The election to adopt one of the new alternative thin capitalisation tests, being either the Group Ratio Test or the External Third Party Debt Test.

This publication does not consider the impact of the new legislation on ADIs, as they are not subject to the new rules.

All legislative references contained herein refer to the Income Tax Assessment Act 1997 (Cth) ("ITAA 1997") unless otherwise specified.

[1] Refer paragraph 2.1 of Explanatory Memorandum to Treasury Laws Amendment (Making Multinationals Pay Their Fare Share – Integrity and Transparency) Bill 2023 (Cth).

1. Preliminary Observations on Thin Capitalisation Rules

Preliminary Issues

Three preliminary issues require consideration in respect of the thin capitalisation rules and any interest expenses that may be denied.

1. Rules apply to an "entity"
   Division 820 requires identification of an 'entity' for the rules to apply to. The rules can apply to companies, partnerships, trusts and individuals.

2. Rules apply to a "debt deduction"
   Notably, the new thin capitalisation rules have broadened the definition of 'debt deductions' by removing the requirement that the relevant cost be incurred 'in relation to a debt interest issued by the entity'. Moreover, the definition has been additionally expanded by including amounts that are 'economically equivalent to interest' (s820-40(1)).

3. Deduction must be "otherwise deductible"
   Third, the debt deduction must be otherwise deductible under the income tax legislation. Debt deductions are not automatically deductible simply because they are not limited by the thin capitalisation rules (s820-40(1)(b)).

Prior to 1 July 2023, the thin capitalisation rules applied to three types of entities:

- Outward investors,
- Inward investors; and
- Inward investment vehicles.

From 1 July 2023, the new thin capitalisation rules apply to 'general class investors' (s820-46). This effectively consolidates the previous three entity definitions under the old rules.

As mentioned above, the previous safe harbour test and the worldwide gearing ratio test will be retained for financial entities and ADIs. The previous arm's length test will also be retained for ADIs. Financial entities that are not ADIs can choose the new Third Party Debt Test, and the previous arm's length test for non-ADIs is no longer available.

The new Division 820-AA will deal with thin capitalisation rules for general class investors, including how all or part of the debt deductions may be disallowed under one of 3 tests (s820-46):

- The Fixed Ratio Test (default);
- The Group Ratio Test (elective); or
- The Third-Party Debt Test (elective).

Once an entity is determined to be a 'general class investor', subsequent determinations are required regarding:

- The application of the de minimis threshold;
- The application of the asset threshold.

De Minimis Threshold Debt Deductions < A$2 million

Division 820 does not apply to limit the debt deductions of an entity in a particular year if the total debt deductions of that entity and all its associate entities for that year are $2 million or less (s820-35).

Asset Threshold Australian Assets > 90% of Total Assets

Division 820 does not apply to limit the debt deductions of an outward investing entity if, in a particular income year, the average Australian assets of the entity divided by the average total assets of the entity is more than 90% (s820-37).

Thin Capitalisation – Summary of 8 April 2024 changes		
Framework	Period	Tests
Previous rules – Division 820	Pre-1 July 2023	Safe harbour debt test Worldwide gearing test Arm's length debt test
New rules – Division 820-AA	1 July 2023 onwards	Fixed Ratio Test Group Ratio Test External Third-Party Debt Test

2. Fixed Ratio Test

The Fixed Ratio Test is the default test that applies to an entity from 1 July 2023 (s820-46(1)(b)(i)), unless an election is made to choose either the Group Ratio Test or the External Third-Party Debt Test (s820-46(3), s820-46(4), s 820-47).

Under the Fixed Ratio Test, an entity's debt deductions for an income year will be disallowed to the extent its "net debt deductions' exceed 30% of the entity's "Tax EBITDA" (s820-50), (s820-51).

If an entity wishes to revoke such an election, it must apply for such a revocation within the four-year period commencing on the lodgement date of the relevant income tax return (s820-47(6)).

Tax EBITDA

"Tax EBITDA" is a new term for thin capitalisation purposes and is defined as earnings before interest, taxes, depreciation, and amortisation (s820-52).

Broadly, the process for calculating an entity's "Tax EBITDA" is summarised in the below table (s820-52).

Tax EBITDA Calculation Steps	
Step	Description
1	Work out the taxable income or tax loss position, disregarding the operation of the thin capitalisation rules and treating a tax loss as a negative amount.
2	Add-back the entity's "net debt deductions" for the income year.
3	Add-back the entity's decline in value of depreciating assets (Subdivision 40-B) and capital works deductions (Division 43) for the income year.
4	Add-back the entity's deductions for tax losses from earlier income years. The amount resulting after Step 4 is the "tax EBITDA" for the income year. If the result at Step 4 is less than zero, the "tax EBITDA" is zero.

Net Debt Deductions

Step 2 of the "Tax EBITDA" calculation requires determination of the entity's "net debt deductions". An entity's "net debt deductions" are the entity's debt deductions, less any assessable income that is interest (s820-50(3)).

Where a debt deduction is disallowed by the Fixed Ratio Test, an entity may carry forward these amounts for up to 15 years (s820-56).

A "special deduction" may then be available to claim previously disallowed deductions in a later income year, subject to the application of the Fixed Ratio Test and certain other conditions.

These conditions include companies passing a modified version of the continuity of ownership test (COT) or business continuity test (BCT).

The above new approach ensures that a portion of a business' profit remains subject to Australian income tax and cannot be eroded by excessive debt deductions.

Tax EBITDA Calculation Example

The below table illustrates how Tax EBITDA is calculated under the thin capitalisation rules as they apply to general class investors under the following example fact pattern:

1. In the year ended 30 June 2024, Australia Subco has incurred an interest expense of A$6 million paid by Australia Subco to US Parentco.
2. The balance sheet of Australia Subco as at 30 June 2024 provides:
   a. Total Assets of $A100 million;
   b. Total Liabilities of A$70 million;
   c. Total Equity of A$30 million.

The income tax return workings of Australia Subco for the year ended 30 June 2024 provide:

1. A$5 million of taxable income;
2. A$10 million of decline in value of depreciating assets;
3. A$7.5 million of capital works deductions; and
4. A$20 million of total debt deductions.

Tax EBITDA Calculations		
Step	Description	Application - Australia Subco
1	Taxable income less: Dividend income / franking credits received from an associate Notional deductions from R&D activities	Taxable income = $5 million No dividends received from associates No R&D activities Step 1 amount = $5 million
2	Add back: Net debt deductions	Total debt deductions = $20 million No interest income Net debt deductions = $20 million Step 2 amount = $25 million
3	Add back: Decline in value deductions (Division 40) Capital works deductions (Division 43)	Decline in value deductions = $10 million Capital works deductions = $7.5 million Total add backs: $17.5 million Step 3 amount = $42.5 million
4	Add back: Prior year deductions for tax losses from earlier income years	No such deductions provided for Step 4 amount = $42.5 million
		Tax EBITDA = $42.5 million

Amount of Debt Deduction Denied

The Fixed Ratio Test denies debt deductions for a taxpayer in an income year to the extent that they exceed the taxpayer's 'fixed ratio earnings limit' for that year (s820-50).

An entity's fixed ratio earnings limit for an income year is 30% of its Tax EBITDA for the income year (s820-51). In the previous example, Australia Subco's fixed ratio earnings limit would be A$12.75 million, being 30% of A$42.5 million.

As Australian Subco has $20 million of net debt deductions pre-application of the fixed ratio test, $7.25 million of its debt deductions will be denied. This amount of $7.25 million may be carried forward for up to 15 years and claimed in a future year as a deduction if Australia Subco's net debt deductions in a future year fall short of its fixed ratio earnings limit in that year, provided certain conditions are met (s820-56).

While the Fixed Ratio Test is the default test, taxpayers have the option to apply one of two alternative tests (s820-46):

- The Group Ratio Test, or
- The Third-Party Debt Test.

A choice to apply a particular test relates to a particular income year. A choice can only be revoked via application to the Commissioner within four years of lodgement (or the due date for lodgement, whichever is earlier) of the relevant income tax return (s820-47(6)).

3. Alternate Thin Capitalisation Tests: Group Ratio Test

If an entity is part of a sufficiently leveraged group, it can elect to apply the group ratio test, whereby net debt deductions are instead denied to the extent that they exceed the entity's 'group ratio earnings limit' for the year (s820-50).

The Group Ratio Test replaces the worldwide gearing debt test for all general class investors.

'GR Group', 'GR Group Parent' & 'GR Group Member'

The Group Ratio Test is only available to a general class investor entity if the entity is a member of a 'GR group' (s820-53(2)), and the group's 'GR group EBITDA' for the period exceeds zero (s820-46(3)(b)).

The definition of 'GR group' ensures that offshore and domestic entities can access the group ratio test (s820-46, s820-53 and s995-1).

A 'GR group', for a period, is the group comprised of the relevant 'worldwide parent entity' or 'global parent entity' and each other entity that is fully consolidated on a line-by-line basis in the relevant financial statements (s820-53).

A 'GR group' cannot be comprised of just one entity (s820-53(2)).

A 'GR group parent' is a GR group's worldwide parent entity.

A 'GR group member' is any member of the GR group, including the worldwide parent entity.

For a GR group to exist, the GR group parent entity must have one of the following:

- Audited consolidated financial statements for the period as defined in s820-935 (s820-53(2(a)), or
- Global financial statements as defined in s960-570 (820-53(2(b)).

The reliance on accounting concepts is intended to minimise compliance costs, as the calculation of the group ratio will be based on figures that are already required to be calculated as part of the worldwide or global parent's consolidated financial reports. This is similar to the current process of calculating worldwide debt under the asset-based rules.

An entity's 'group ratio earnings limit' is calculated as the entity's 'group ratio' for the income year multiplied by its tax EBITDA for the year (s820-51).

An entity's 'group ratio' for an income year is calculated by reference to information contained in the relevant audited financial statements for the GR group parent for the group for the period corresponding to the relevant income year.

In certain circumstances, taxpayers will be required to make adjustments to the amounts disclosed in the relevant financial statements to include amounts equivalent to interest and to disregard certain payments to associated entities.

The Group Ratio Test for an income year is worked out as follows:

Calculation of Group Ratio	
Step	**Description**
1	Work out the GR Group Net Third Party Interest Expense of the GR Group.
2	Work out the GR group EBITDA of the GR group.[2]
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.
4	If the result of Step 2 is zero, the entity's group ratio for the income year is zero.

Given the above, the new Group Ratio Test provides further terms which define:

- GR Group Net Third Party Interest Expense – (s820-54)
- GR Group EBITDA and entity EBITDA – (s820-55)

Group Ratio Test – and the term "GR Group's Net Third Party Interest Expense"

The GR Group Net Third Party Interest Expense is relevant to calculating the group ratio earnings limit (section 820-54).

The GR Group Net Third Party Interest Expense is the amount that would be the GR Groups net third party interest expense per the group's financial statements and as adjusted by section 820-54, including adjustments for payments from and to associated entities outside the group.

Group Ratio Test – and the term "GR Group EBITDA"

The GR Group EBITDA is relevant to calculating the Group Ratio Earnings Limit (section 820-55).

The GR Group EBITDA is the sum of the following amounts:

1. GR Group's net profit (disregarding tax expenses);
   a. However, where the entity's EBITDA for the period is less than zero, the entity's EBITDA is disregarded from the determination of the GR Group's EBITDA (s820-55(3));
2. GR Group's adjusted net third party interest expense; and
3. GR Group's depreciation and amortisation expenses as disclosed in the audited consolidated financial statements or global financial statements.

The requirement for the GR Group EBITDA to be at least zero is necessary to ensure the meaningful application of the group ratio test and to prevent entities from exploiting its operation to claim excessive debt deductions that are not linked to their profits. This is consistent with the OECD best practice guidance (section s820-36(3)(b) and s820-55).

---

[2] Note, s820-46(3)(b) effectively prohibits an entity from applying the group ratio test if the GR group EBITDA is zero or less.

The Explanatory Memorandum to the new thin capitalisation does not contain any practical examples in relation to the operation of the Group Ratio Test. Adopting the facts in example 8 in the 2016 OECD Report "Limiting Base Erosion involving Interest Deductions and Other Financial Payments – 2016 Update" ("OECD Report), an entity's group ratio would be calculated as follows.[3]

Example 8 - Table 1.D.6. OECD Report				
	Financial Reporting		Tax	
	Net interest expense USD	EBITDA USD	Net interest expense USD	EBITDA USD
Group	(100 million)	1 billion	n/a	n/a
A Co	(20 million)	100 million	(18 million)	80 million

Step	Definition of Group Ratio	Application
1	Work out the GR Group Net Third Party Interest Expense of the GR Group	USD 100 million
2	Work out the GR group EBITDA of the GR group.[4]	USD 1 billion
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.	10%
4	If the result of Step 2 is zero, the entity's group ratio for the income year is zero	

(see s820-51 and s820-53)

Amount of Debt Deduction Disallowed

An entity's Group Ratio Earnings Limit is the entity's Group Ratio for the income year multiplied by its tax EBITDA for the income year (s820-51).

For example, if the entity has a Group Ratio of 10% and a tax EBITDA of USD 80 million, the entity's Group Ratio Earnings Limit is USD 8 million.

If the entity's total interest expense is USD 18 million, USD 8 Million is deductible and USD 10 million is disallowed under the Group Ratio Test (s820-50(1)(c)).

A taxpayer must elect to adopt the Group Ratio test (s820-47).

There is no entitlement to carry forward denied deductions under the Group Ratio Test (s820-56).

[3] *Example 8 appears at page 109 of the OECD Report and is at located https://www.oecd-ilibrary.org/*

[4] *Note, s820-46(3)(b) effectively prohibits an entity from applying the group ratio test if the GR group EBITDA is zero or less.*

3. Alternate Thin Capitalisation Tests: Third Party Debt Test

The Third Party Debt Test effectively disallows an entity's debt deductions to the extent that they exceed the entity's third party earnings limit for the income year (s820-50(1)(c)).

The Third Party Debt Test replaces the arm's length debt test for general class investors and financial entities. However, ADIs will continue to have access to the arm's length debt test.

The test is intended to be simpler than the previous arm's length debt test, which operates based on valuation metrics and the 'hypothesised entity comparison'.

The Third Party Debt Test is designed to accommodate only genuine commercial arrangements relating to Australian business operations. It is not intended to accommodate all debt financing arrangements that may be accepted as current practice.

If the Third Party Debt Test applies for an income year, the amount of an entity's debt deductions for the income year that is disallowed is the amount by which the entity's debt deductions exceed the entity's third party earnings limit for the income year (s820-427).

Third Party Earnings Limit

An entity's 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 Third Party Debt Conditions (s820-427A(1)).

Third Party Debt Conditions

A debt interest issued by an entity satisfies the Third Party Debt Conditions in relation to an income year if the following conditions are satisfied:

1. The issuing entity is an Australian resident;
2. The entity issued the debt interest to an entity that is not an associate entity of the entity;
3. The debt interest is not held at any time in the income year by an entity that is an associate entity of the entity;
4. The holder of the debt interest has recourse for payment of the debt only to Australian assets held by the entity. However, recourse to assets of the entity that are rights under or in relation to a guarantee, security or other form of credit support are prohibited, unless specified circumstances apply; and
5. The entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia. The term 'all, or substantially all' is adopted to cover circumstances where all of the proceeds are used for the relevant activities but accommodating a minor or incidental use of the proceeds for other activities.

(s820-427A(3))

The above conditions aim to ensure the third party debt test only captures genuine third party debt which is used to fund Australian business operations.

Additional rules exist for conduit financing arrangements (s820-427B and s820-427C). The taxpayer must elect to adopt the Third Party Debt Test (s820-47), and there is no entitlement to carry forward denied deductions under the Third Party Debt Test (s820-56).

Concluding Remarks

To summarise, the old debt deduction tests have been effectively replaced for those entities previously categorised as either ‘outward investors’, ‘inward investors’ and ‘inward investment vehicles’. These categories have been subsumed under the label ‘general class investors’.

The new tests are the Fixed Ratio Test, the Group Ratio Test and the Third Party Debt Test.

The previous 'safe harbour test', 'worldwide gearing test', and 'arm's length test' are only relevant for ADIs and plantation entities. For non-ADI 'financial entities', only the old 'safe harbour test', the 'worldwide gearing test' and the new Third Party Debt Test are relevant.

In brief, the new Fixed Ratio Test is the default test and, where applicable, only allows entities to claim net debt deductions up to 30% of tax EBITDA.

Entities may however elect to be subject to the Group Ratio Test or the Third Party Debt Test.
The Group Ratio Test allows entities to claim net debt deductions up to the ratio of the worldwide group's net interest expense to EBITDA, but with certain adjustments.

Under the new Third Party Debt Test, only debt deductions attributable to debt interests that satisfy the third party debt conditions in an income tax year will be allowed.

Whether an election to adopt the Group Ratio Test or the Third Party Debt Test is advisable will depend on your particular circumstances.

Moreover, an additional and important aspect of the new thin capitalisation regime is the expansion of the definition of 'debt deduction' to cover amounts 'economically equivalent to interest'.

The requirement that the relevant cost be incurred 'in relation to a debt interest issued by the entity' has also been removed.

CONTACT US

Contact one of Hall Chadwick's Corporate Tax experts if you would like to discuss how the new thin capitalisation rules may affect you.

Rick Hopkins

Director - Taxation

+61 8 9426 0666

rhopkins@hallchadwickwa.com.au

Jason Chute

Senior Analyst - Corporate Tax

+61 8 9426 0666

jchute@hallchadwickwa.com.au

Gino Malacco

Partner

+61 2 9263 2600

gmalacco@hallchadwick.com.au

Jian (Buck) Xiao

Director

+61 3 9820 6400

bxiao@hallchadwickmelb.com.au

Shana Soares

Analyst - Corporate Tax

+61 8 9426 0666

ssoares@hallchadwickwa.com.au

HALL CHADWICK