AUSTRALIA’S NEW DEBT DEDUCTION LIMITATION REGIME

After a long journey, the Government's fundamental changes to Australia’s tax debt deduction limitation regime have now been passed by Parliament and await Royal Assent

Overview and practical considerations

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NEW TAX DEBT LIMITATION RULES

APPLICATION DATES

- 1 July 2023 (thin capitalisation)
- 1 July 2024 (debt deduction creation)

Note: No grandfathering for existing arrangements under either regime

SCOPE OF ENTITIES CAPTURED

- Unchanged: Applies to Australian entities investing offshore, foreign controlled Australian entities and foreigners operating via a permanent establishment (PE). Such entities are now known as "General Class Investors" unless they are financial entities or Authorised deposit-taking institutions (ADIs)
- You not need to consider the new thin cap rules if:*
  - Your debt deductions, together with your associates, are A$2m or less
  - You are an Australian group that is not foreign controlled and 90% or more of your assets are "Australian"

* Separate exemptions apply to the debt deduction creation rules

ORDER OF APPLICATION OF RULES

In considering the quantum of debt deductions denied:

1. Apply transfer pricing rules
2. Amounts allowed after step 1 are then subject to debt deduction creation rules
3. Amounts (if any) allowed after step 2 are then subject to the thin capitalisation rules

OLD RULES

SAFE HARBOUR DEBT TEST

Debt deductions limited to 60% of adjusted assets (general investors) with specific safe harbours for financial entities and ADIs (e.g., the financial entity 15/16 debt to equity safe harbour)

ARM'S LENGTH DEBT TEST

Applies to all classes of investors

WORLDWIDE GEARING TEST

Applies to all classes of investors

EXEMPTIONS/CONCESSIONS

Available for securitisation vehicles,* and special purpose entities that satisfy particular conditions

A$2m de minimis and 90% "Australian assets" exemptions

* Note that securitisation vehicles may qualify for concessional rules in calculating maximum allowable debt

NEW RULES

FIXED RATIO TEST

Debt deductions limited to 30% of Tax EBITDA for all General Class Investors other than financial entities and ADIs (who continue to apply existing safe harbour debt test). May carry forward denied deductions for up to 15 years

THIRD PARTY DEBT TEST

Applies to entities other than ADIs (who can continue to apply existing arm's length debt test)

GROUP RATIO TEST

Available to all entities other than financial entities and ADIs (existing worldwide gearing rules may apply)

EXEMPTIONS/CONCESSIONS

Remain unchanged

DEBT CREATION RULES

No current equivalent: Limits deductibility of certain related party debt (see below)

THINGS TO NOTE

- Expanded definition of debt deductions captured by the new rules, which includes amounts "economically equivalent to interest", and that debt deductions are no longer required to be "in relation to a debt interest"
- If relying on the third party debt test (TPDT):
  - No ability to claim deductions for related party debt
  - All associates are deemed to also apply the TPDT
- More restrictive requirements to qualify as a financial entity – entities previously relying on registration under FSCODA now have additional conditions
- Year by year irrevocable election for the TPDT or group ratio test (GRT). No ability to carry forward denied deductions if you have elected into the TPDT or GRT

OVERVIEW OF THE NEW THIN CAPITALISATION RULES

FIXED RATIO TEST (FRT)

DEFAULT TEST

Denies net debt deductions of an entity that exceed 30% of the entity's tax EBITDA.

TAX EBITDA

Calculated as taxable income or tax loss + net debt deductions + decline in value deductions and capital works deductions. Only includes distributions from equity investments in EBITDA where you have less than 10% ownership.

NET DEBT DEDUCTION

Unlike the old rules, new rules only disallow **net** debt deductions: being, broadly, debt deductions *less* assessable debt income (i.e., interest and amounts economically equivalent to interest).

CARRY FORWARD OF DENIED DEDUCTIONS

15 year carry forward subject to continuity of ownership / business tests. Electing out of FRT results in the loss of any carried forward debt deductions.

USE OF "EXCESS" EBITDA

Entities holding 50% or more of another entity with excess tax EBITDA can include their share of the excess in their own tax EBITDA where certain conditions are satisfied.

GROUP RATIO TEST (GRT)

BY ELECTION ONLY

Denies net debt deductions by reference to a group ratio earnings limit.

Available to Australian entities in a global group where:

- group's tax EBITDA is positive; and
- the parent entity has audited or global financial reports (**relevant statements**).

GROUP RATIO EARNINGS LIMIT

Is equal to the entity's group ratio x entity's tax EBITDA.

GROUP RATIO

Is equal to the group's net third party interest expense divided by Group EBITDA.

NET THIRD PARTY INTEREST EXPENSE

The net third party interest expense may be disclosed in the relevant statements. If not disclosed in the relevant statements, it is equal to the group's **third party interest expenses** (excluding payments to associates) less the group's **third party interest income** (excluding payments to associates) as disclosed in the relevant statements.

Note: The GRT is calculated differently from the FRT.

THIRD PARTY DEBT TEST (TPDT)

BY ELECTION ONLY

Allows gross debt deductions in respect of third party debt which satisfies the **third party debt conditions**.

THIRD PARTY DEBT CONDITIONS

- borrower not associated with lender;
- disregarding recourse to minor or insignificant assets, recourse for payment only against "covered" Australian assets and which are not rights under or in relation to a guarantee, security or other form of credit support (unless specifically permitted (e.g., rights that relate wholly to developing an offshore renewable energy infrastructure, or relates to the development of land);
- all, or substantially all, of the proceeds of debt are used to fund commercial activities in connection with Australia that do not include:
  - any business carried on by the entity through an overseas permanent establishment; and
  - the holding of any associated entity debt, controlled foreign entity debt or controlled foreign entity equity.

The concepts of "substantially all", "minor or insignificant", and "Australian assets" are not defined. However, it is hoped that ATO guidance may be released to assist in interpreting these terms.

CONDUIT ARRANGEMENTS

Ability to on-lend within a group and rely on test in limited cases.

OVERVIEW OF DEBT DEDUCTION CREATION RULES

OVERVIEW

Scope

The following entities are covered:

- General Class Investors; and
- Outward and inward investing financial entities (non-ADI).

Exclusions: ADIs, securitisation vehicles, certain insolvency remote SPVs, entities with total debt deductions of <$2M, third party debt arrangements, and entities choosing the TPDT.

The debt deduction creation rules (**DDCR**) completely deny debt deductions incurred in relation to associate debt in the following circumstances.

(Type 1) *Asset or obligation acquisition*

- An entity acquires a CGT asset or obligation directly or indirectly from an associate.
- The entity, or an associate, incurs debt deductions in relation to the acquisition.
- Exceptions:
  - Acquisitions of new membership interests in Australian entities or foreign companies, new tangible depreciating assets and new loans to associates (so mere related party lending is not caught).

(Type 2) *Associate borrowing to fund associate payment*

- An entity borrows from an associate to fund a payment or distribution to another associate. The rules originally applied very broadly, but following consultation the categories of payments / distributions covered under Type 2 were specifically identified as those in the following list.
  - This rule should not apply to debt deductions on funds borrowed to repay principal amounts of debt that would not themselves be Type 2 debt.

COMMON TRANSACTIONS THE RULES MAY APPLY TO

The following types of payments / distributions covered under Type 2 are:

- dividends, distributions or non-share distributions;
- trustee or partnership distributions;
- returns of capital;
- cancellations or redemptions of membership interests;
- royalties or similar; or
- repayment of principal under a debt interest caught by Type 2.

The rules can apply where:

- Assets are transferred between members of a group of Australian trusts (e.g., as part of portfolio rebalancing) and the consideration is in the form of a debt.
- The original use of existing, refinanced, or new related party borrowing was to acquire an asset or obligation, or fund an associate payment (therefore requiring tracing to determine the original use).

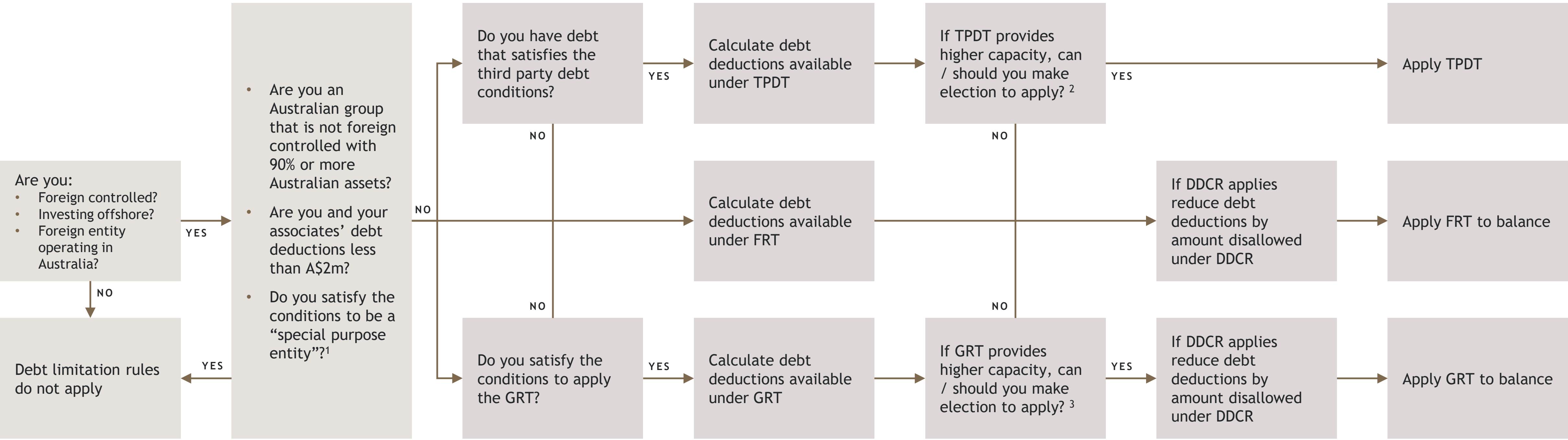
Anti-avoidance:

- Debt deductions will be denied in circumstances where there is a “principal purpose” to avoid the application of the DDCR (**DDCR anti-avoidance rules**).
- The Supplementary EM explains that the DDCR anti-avoidance rules will not apply to “merely restructuring, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt creation rules”. However, this statement does not appear in the legislation. It is hoped that the ATO may provide guidance on this and restructuring for the new rules more generally.

ROADMAP TO APPLICATION OF RULES: INVESTORS OTHER THAN FINANCIAL ENTITIES AND ADIS

ARE YOU SUBJECT TO THE THIN CAPITALISATION RULES?

WHAT THIN CAPITALISATION RULES SHOULD YOU APPLY?



Notes

1. These are insolvency remote vehicles that satisfy certain conditions. Note that securitisation vehicles may qualify for concessional rules in calculating maximum allowable debt.
2. Need to consider consequences of making this election including: (i) you can no longer carry forward any FRT denied deductions; (ii) it must be made by all associates; and (iii) choice is irrevocable except where the Commissioner exercises discretion.
3. Need to consider consequences of making this election including that you can no longer carry forward any FRT denied deductions.

Note that the debt deduction creation rules may apply even where the thin capitalisation rules do not apply more generally.

This roadmap is necessarily presented at a high level and should not be viewed as a substitute for a detailed review of the relevant rules which are complex.

PRACTICAL CONSIDERATIONS

- **Need to review all existing debt arrangements for which deductions are being claimed – no grandfathering under either regime**
- **When looking to elect into TPDT / GRT – need to consider consequences of those elections**
- **Where restructuring is required to comply with the new rules, anti-avoidance provisions should be considered (subject to potential ATO guidance)**

PRACTICAL & STRUCTURAL CONSIDERATIONS

TPDT

- Provision of foreign related party guarantees prohibited – possibly managed by the provision of guarantees by the highest tier Australian entity in the group
- Australian groups with foreign assets – attempt to exclude recourse to such foreign assets
- Associate requirements – typically, where an entity chooses the TPDT its associates must also (the rules reduce the normal 50% threshold for associate testing to 20%)
- Consider ability to restructure to access the TPDT

FRT

- Careful consideration of what is included in tax EBITDA
- Ability to access excess EBITDA in co-investment or JV arrangements is practically limited to 50/50 ownership – consider other options such as where one entity has 50% or more, or no entities have 50% (i.e., 3 partners with 33%)
- Consideration of debt placement within non-consolidated groups

DDCR

- Denies debt for acquisitions indirectly from an associate – must trace ownership of acquired assets or obligations
- Entities in a tax consolidated group may more easily apply the rules - however, difficulties remain for groups of trusts
- Rules look to original use of the debt – must trace existing, refinanced, or new related party borrowing

GRT

- Consider where an entity forms part of a highly leveraged group to allow deductions beyond the fixed ratio
- Complexity of calculation by reference to global or audited consolidated statements

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