June 2023

Tax Alert

Thin capitalisation measure introduced into Parliament

At a glance

- Legislation to amend the thin capitalisation provisions to align with OECD earnings-based model:
  - 30% of tax EBITDA
  - Group ratio test
  - Third party debt test.
- Separate transfer pricing analysis required for debt quantum prior to applying ratio based tests.
- New debt creation rules introduced that potentially have broad application.
- Changes to section 25-90 deferred.
- Application date of public Country-by-Country Reporting proposed to be deferred, with a reduction in disclosures required.

On 22 June 2023, the Australian Federal Government introduced *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023* (the Bill) into Parliament, following consultation on Exposure Draft legislation.

The Bill proposes to replace the current asset-based thin capitalisation rules with three new tests:

- A default fixed ratio test based on 30% of tax EBITDA (replaces the safe harbour test for all general class investors)
- A group ratio test (replaces the worldwide gearing test for all general class investors)
- An external third party debt test for general class investors and financial entities that are not authorised deposit-taking institutions (ADIs).

The fixed ratio test and group ratio test are not safe harbour provisions and represent a ceiling on net debt deductions only. A transfer pricing analysis will be required to support the debt quantum, prior to applying the earnings-based ratio tests (other than third party debt with no related party guarantees or security).

Financial entities and ADIs will continue to be subject to the existing thin capitalisation rules.

The new measures will apply for income years commencing on or after 1 July 2023.

The Bill contains a number of key changes from the Exposure Draft law in the application of the three new tests.

While the changes to section 25-90 proposed in the Exposure Draft law have been deferred, the Bill unexpectedly introduces new debt creation rules, which deny deductions for interest on borrowings to either acquire assets from related parties or to fund dividends or other distributions to related parties.

Tax transparency

Public Country-by-Country Reporting

In addition, the Explanatory Memorandum contains an impact statement on the proposed public Country-by-Country Reporting (CbCR) measure. This impact statement includes an updated proposed approach that reduces the disclosures to some extent, but still goes beyond the confidential CbCR and the EU public CbCR disclosures. The Explanatory Memorandum foreshadows that the application of the proposed public CbCR measure will be postponed and that there will be further consultation.

Disclosure of subsidiaries

The Bill introduces new Corporations Act requirements for Australian public companies (listed and unlisted) to disclose information about their subsidiaries in their annual financial reports, for financial years commencing on or after 1 July 2023.

If the accounting standards require the public company to prepare financial statements in relation to a consolidated entity, the 'consolidated entity disclosure statement' in the company's annual financial reports must provide the following information in relation to entities within the consolidated entity:

- The names of each entity at the end of the financial year
- Whether the entity was a body corporate, partnership or trust at the end of the financial year
- Whether at the end of the financial year, the entity was a trustee of a trust within the consolidated entity, a partner in a partnership within the consolidated entity or a participant in a joint venture within the consolidated entity
- If the entity is a body corporate, where the entity was incorporated or formed and the public company's percentage ownership (whether directly or indirectly) of each of those entities that are body corporates at the end of the financial year
- The tax residency of each of those entities during the financial year.

Public companies that are not subject to the rule (ie. no consolidated statements) must state this in their annual financial report. There are no substantive changes from the previous Exposure Draft law to the Bill.

Changes to thin capitalisation measure

General class investor

The new thin capitalisation provisions will apply to general class investors, which amalgamates the existing general classes of entities, ensuring the new tests apply to:

- An Australian entity that carries on business in a foreign country at or through a permanent establishment or through an entity that it controls
- An Australian entity that is controlled by foreign residents, and
- A foreign entity having investments in Australia.

These definitions have not changed from the Exposure Draft law.

Financial entities (as per the amended definition) and ADIs will continue to be subject to the existing thin capitalisation rules.

Definition of financial entity

Paragraph (a) of the definition of financial entity in subsection 995-1(1) will be amended to include two additional conditions for entities that are a registered corporation under the *Financial Sector (Collection of Data) Act 2001* (Cth). These conditions will require that the entity be carrying on a business of providing finance (but not predominantly to associates) and that it derives all or substantially all of its profits from that business.

This is a change from the Exposure Draft law which had proposed to repeal paragraph (a) entirely. Entities that satisfy the requirements of the amended definition will remain subject to the existing thin capitalisation rules.

Fixed ratio test

The fixed ratio test will be the default test for general class investors who have not made a choice to apply either the group ratio test or the third party debt test. Under the fixed ratio test, an entity's net debt deductions will be capped at 30% of its tax EBITDA (fixed ratio earnings limit).

An entity's tax EBITDA will be calculated as follows:

- Work out the entity's taxable income or tax loss for the year (disregarding the application of the thin capitalisation rules)
- Add the entity's net debt deductions for the year
- Add the entity's decline in value deductions (under Division 40) and capital works deductions (under Division 43)
- If the result is less than zero treat it as zero.

Following consultation, the depreciation add back has been broadened to that included in the Exposure Draft law. This now includes all deductions under Division 40 and Division 43 except amounts that are immediately deductible (eg. amounts deducted under subdivision 40-H).

It is also noted that utilisation of prior year tax losses will not be adjusted in the calculation of tax EBITDA, which is a change from the Exposure Draft law.

In calculating an entity's tax EBITDA, certain adjustments will be required to prevent the duplication of EBITDA capacity:

- Dividends (as well as franking offsets) will be excluded from the entity's taxable income
- For an entity that is a partner in a partnership or a beneficiary of a trust, the share of the net income of the partnership / trust will be excluded from the entity's taxable income where the entity is an associate entity of the partnership or trust.

These adjustments will impact non-consolidated group structures and will require that debt be issued at the project entity level rather than at the investor or holding entity level. This will be a critical issue for many real estate and infrastructure projects, where such structures are common. There are a number of key issues that will need to be appropriately addressed for trusts to apply the fixed ratio test (e.g. not reduce net income by CGT discount). Impacted entities will need to review their structures and funding arrangements. The new debt creation rules (discussed below) will also need to be considered in respect of any restructuring of funding arrangements.

FRT disallowed amount

As with the Exposure Draft law, debt deductions previously disallowed under the fixed ratio test (FRT disallowed amount) may be carried forward for 15 years (subject to satisfying certain conditions) and will be deductible in a subsequent year where the entity's net debt deductions are less than the fixed ratio earnings limit in that year.

The entity will need to apply the fixed ratio test in all relevant income years to be able to deduct any FRT disallowed amount in a later income year (ie. if a choice is made to use either the group ratio test or the third party debt test in an intervening income year, the FRT disallowed amount will not be carried forward).

Companies will have to satisfy either a modified continuity of ownership test (COT) or business continuity test (BCT) to be able to utilise the FRT disallowed amount in a later year. The addition of the BCT as an alternative test is a welcome change from the Exposure Draft law.

Trusts will need to satisfy a modified version of the trust loss rules.

These changes mean the FRT disallowed amount will be treated in much the same way as a tax loss.

Tax consolidation

The FRT disallowed amounts may be transferred to the head company of a tax consolidated group on joining or formation, applying either a modified COT or BCT as a transfer test. The addition of the BCT as a transfer test is welcome and should mean that FRT disallowed amounts are able to be transferred to the head company in most acquisition scenarios. The 15 year period for using the FRT disallowed amounts is not refreshed when transferred to the tax consolidated group.

In a change from the Exposure Draft law, the head company may choose to cancel the transfer of an FRT disallowed amount.

An adjustment is made to reduce the joining entity's ACA for the tax effect of the FRT disallowed amount transferred.

The FRT disallowed amount stays with the consolidated group if that entity leaves the group.

Group ratio test

The group ratio test has largely remained unchanged since the Exposure Draft law. The key changes are definitional in nature, as follows:

- Adjusted net third party interest expense is defined as the amount that would be the entity's net interest expense if payments made by the entity to an associate entity or by an associate entity to the entity were disregarded. The definition of associate entity for this purpose was originally proposed to be modified such that it would be determined based on a 10% or more TC control interest, reduced from the current 50% threshold. The Bill increases the modified definition of associate entity to be a 20% or more TC control interest, which will reduce the amount of interest payments to associated entities that will be disregarded and the compliance burden of tracking such payments.
- Similar to the proposed amendment to the definition of debt deduction in subsection 820-40(1)(a)(i), the definition of GR group net third party interest expense has been expanded to not only include any amount of interest or an amount in the nature of interest but also any other amount that is economically equivalent to interest. This broader definition is intended to include interest related costs under swaps, such as interest rate swaps.
- The definition of GR Group has been expanded to not only include (a) the group comprised of the relevant worldwide parent entity and entities consolidated (line-by-line) in its audited financial statements but also, where (a) does not apply, the group comprised of the global parent entity and entities consolidated (line-by-line) in global financial statements (as defined in section 960-570). The expanded definition of GR Group is intended to ensure that an offshore and domestic parent entity can access the group ratio test.
- GR Group EBITDA is defined as the sum of the GR group's net profit (disregarding tax expenses); adjusted for net third party interest expense; and depreciation and amortisation expenses. However, we note that in working out the GR Group EBITDA which includes one or more entities with a negative entity EBITDA, those negative amounts are excluded.

Third party debt test

Consistent with the previous ED, the third party debt test allows all debt deductions which are attributable to third party debt that satisfies certain other conditions. Taxpayers who have related party debt and have historically relied on the arm's length debt test will need to consider the consequences under the fixed ratio test or group ratio test which may operate as a cap on debt deductions, and also prepare a separate transfer pricing analysis, or credit assessment test similar to that required under the existing arm's length debt test.

The third party debt test includes a condition that the lender only has recourse to the Australian assets of the borrower. There is no materaility or de minimis threshold included in the Bill. The third party debt test also prohibits lender's recourse to Australian assets which are in any way guaranteed or secured by any form of credit support, excluding the special exception for certain credit support provided by Australian residents in respect of certain greenfield developments of real property (i.e. land and buildings) situated in Australia. Notably, this special exception is intended to only apply during the development phase of the real property.

The previous Exposure Draft law proposed that an election to rely on the external third party debt test would apply on a one-in-all-in basis to be applicable to all associate entities of the borrower. Treasury acknowledged the difficulty in taxpayers complying with the one-in-all-in election style, in particular where the application on an associate-inclusive basis would extend to entities which the borrower did not control. Accordingly, Treasury has sought to limit the deemed application of the third party debt test to a smaller subset of all associate entities of the borrower which are also a member of the obligor group in relation to the debt arrangement in question. Taxpayers within an obligor group need to be mindful of the automatic application of the test (where it is applied or deemed to have been applied by a separate associate entity) which would prevent deductibility of any related party debt deductions in their entirety. There are further amendments to the definition of associate entity which apply when considering the deemed application of the third party debt test which need to be considered carefully.

The conduit financier rules in the revised Bill were also relaxed somewhat with the extent to which the on-lent debt must mirror exactly the terms and conditions of the third party debt. This includes provisions to allow for the recovery of administrative costs and /or relevant hedging costs, without disqualification from the conduit financing entity provisions.

Transfer pricing and thin capitalisation interaction

Consistent with the Exposure Draft law, the repeal of section 815-140 (for general class investors), which dealt with the interaction between the thin capitalisation and the transfer pricing provisions, has been retained. The Explanatory Memorandum emphasises that before applying the new earnings-based thin capitalisation tests, the arm's length conditions will need to be assessed from a transfer pricing perspective, including both the appropriate amount of debt and the applicable interest rate. Consequently, the fixed ratio test / group ratio test do not automatically allow net debt deductions up to the calculated threshold (i.e. the ratio tests represent a ceiling and not a safe harbour). This is a significant deviation from the historical thin capitalisation provisions, which did not require a separate transfer pricing analysis to assess the quantum of debt, where this was within the asset-based safe harbour limit.

The analysis which will be required to support the debt quantum will be analogous in many ways to the economic assessment of an arm's-length capital structure which was required under the former arm's length debt test. This would typically involve an analysis of borrowing capacity with reference to relevant financial ratios that an independent lender would consider, as well as debt/equity and risk profile that would be expected to be accepted by shareholders in the market. In this context, taxpayers need to be mindful that this analysis will be expected to consider a range of financial ratios relative to comparable industry peers, such as: interest cover, debt service cover, Debt to EBITDA and Debt to Equity. The analysis may also extend to the overall structure of debt finance as part of the arm's length conditions.

This analysis is potentially complex and may be onerous for taxpayers seeking to document their self-assessment position for transfer pricing purposes in relatively conservative gearing scenarios. It is unclear at this stage whether the Commissioner will subsequently release any Practical Compliance Guidelines, which would assist taxpayers in documenting low risk scenarios, where a comprehensive analysis would be inappropriately burdensome relative to the risk profile of the debt.

Debt creation rules

The Bill includes the introduction of debt creation rules some 20 years after the former debt creation rules were repealed. The debt creation rules were not included in the Exposure Draft law and were not the subject of any Government announcement.

The new rules are intended to deny debt deductions in income years commencing on or after 1 July 2023 in circumstances where, broadly:

- Interest bearing debt (whether related party or third party) is used to acquire an asset (or an obligation) from an associate
- Interest bearing debt (related party debt only) is used to fund a payment to an associate, including a dividend, return of capital or repayments of principal on a debt interest.

The only taxpayers excluded from the rules are those who satisfy the de minimis test for debt deductions of $2 million or less.

The drafting of the rules, including the lack of any purpose test, means the rules appear to have wide application to a broad range of transactions. For example, an injection of additional equity by a holding company into either an offshore subsidiary, or a domestic subsidiary of a non-consolidated group in return for shares, could result in interest disallowance if the holding company borrowed to make the injection.

It is also not clear whether the rules are intended only to apply to transactions entered into after the application date or whether historic transactions are also subject to the rules if debt deductions are claimed after the application date. There are many aspects of the rules which require refinement or clarification.

The previous debt creation rules introduced in 1988 only applied to Australian entities controlled by a foreign controller. The previous rules excluded various types of transactions, whereas the current rules have a broader application and propose no exclusions.

Moreover, the rules include a specific anti-avoidance provision designed to address schemes seeking to avoid the debt creation rules. The anti-avoidance rule applies a principal purpose test rather than a dominant purpose test and may readily impact any attempts to avoid application of the rules, including for example, the pooling of cash resources to make a related party acquisition followed by borrowing to fund operating outgoings.

Deferral of section 25-90 changes

Following its (unexpected) inclusion in the original Exposure Draft law, we welcome the announcement of the deferral of the proposed amendment of section 25-90 following government consideration of stakeholder concerns regarding its potential application. The proposed amendment is instead to be considered via a separate process, hopefully involving broad and meaningful consultation with industry and impacted taxpayers, albeit with no current guidance as to timing, scope etc.

In the meantime, however, taxpayers will need to consider the impact of the targeted debt creation rules (see above) which have been (per Government) progressed in its place and presumably designed to address some of the concerns regarding section 25-90. There appears to be significant overlap between the two proposals which could mitigate the impact of the deferral. This is expected to be the case, for example, where an Australian MNE acquires a foreign subsidiary from a foreign related party with the purchase funded by way of interest-bearing debt.

How EY can help

- EY teams can assist groups to analyse the new provisions, model impacts and to support your consideration of alternatives going forward.
- EY can assist with transfer pricing analysis to support an arm's length capital structure / debt capacity for companies seeking to apply the fixed ratio test or group ratio test.

For more information please contact:

Sydney
Alf Capito
Tel: +61 2 8295 6473
alf.capito@au.ey.com

Lachlan Coban
Tel: +61 2 9248 4496
lachlan.cobon@au.ey.com

Sean Monahan
Tel: +61 2 8295 6226
sean.monahan@au.ey.com

Matt Weerden
Tel: +61 2 8295 6788
matt.weerden@au.ey.com

Daryl Choo
Tel: +61 2 9248 4472
daryl.choo@au.ey.com

David Burns
Tel: +61 2 9248 5059
david.burns@au.ey.com

Simon Jenner
Tel: +61 2 8295 6367
simon.jenner@au.ey.com

Danielle Donovan
Tel: +61 2 8295 6333
danielle.donovan@au.ey.com

Brisbane
Reid Zulpo
Tel: +61 7 3243 3772
reid.zulpo@au.ey.com

Rebecca Lapraik
Tel: +61 7 3011 3388
rebecca.lapraik@au.ey.com

Melbourne
Richard Goodwin
Tel: +61 3 9288 8545
richard.goodwin@au.ey.com

Andrew Woollard
Tel: +61 3 8650 7511
andrew.woollard@au.ey.com

Tony Merlo
Tel: +61 3 8575 6412
tony.merlo@au.ey.com

Liz Cullinan
Tel: +61 3 8650 7938
liz.cullinan@au.ey.com

Peter Janetzki
Tel: +61 3 8650 7525
peter.janetzki@au.ey.com

Sarah Diss
Tel: +61 3 9288 8230
sarah.diss@au.ey.com

Perth
Andrew Nelson
Tel: +61 8 9429 2257
andrew.nelson@au.ey.com

Mathew Chamberlain
Tel: +61 8 9429 2368
mathew.chamberlain@au.ey.com

Joe Lawson
Tel: +61 8 9429 2489
joe.lawson@au.ey.com

Caroline Walker
Tel: +61 8 9217 1897
caroline.walker@au.ey.com

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