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[Insert client name]

[Insert client position]

[Insert company name]

[Insert client address]

[Suburb state postcode]

Dear [insert client name],

**Re:** **Thin capitalisation and debt deduction creation rules**

Following enactment of the *Treasury Laws Amendment* *(Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024*:

* new thin capitalisation (‘thin cap’) rules will apply to income years on or after 1 July 2023 and
* debt deduction creation rules will apply to income years commencing on or after 1 July 2024.

The new thin cap and debt deduction creation rules replaces the old thin cap regime for ‘general class investors’ set out in Division 820 of the *Income Tax Assessment Act* 1997 (ITAA 1997). In particular, the new thin cap rules introduce the following new tests:

* Fixed Ratio Test (FRT)
* Group Ratio Test (GRT)
* Third Party Debt Test (TPDT)

The above tests disallow an entity’s debt deductions by reference to their earnings, which replaces the previous assets-based tests for general class investors. The introduction of the debt deduction creation rules is also a new concept introduced that did not exist in the previous thin cap regime.

The changes are aimed at reducing risks to the Australian domestic tax base from the use of excess debt deductions, which are more restrictive than the old thin cap rules and likely to result in a greater denial of debt deductions especially for groups with little or no profits.

As taxpayers may have different tax outcomes depending on which test they choose to apply, it is important for taxpayers to review their debt financing arrangements and consult with their tax advisors on the best test to apply under the new thin cap regime. Further, taxpayers with any related party debt arrangements used for the purpose of acquiring assets from associates or to make a prohibited payment (i.e. a dividend or capital return) should consult their tax advisors, as the debt deduction creation rules may apply to disallow all of the related party debt deductions.

In this letter, we provide an overview of the new thin cap rules and debt deduction creation rules, eligibility requirements for the new rules to apply to our debt financing arrangements, and available exemptions.

**NEW THIN CAP RULES**

**Entities subject to the new thin cap rules**

The new thin cap rules apply to ‘general class investors’, which is a consolidation of the previous general classes of entities. Broadly, this includes:

* foreign controlled Australian entities
* foreign entities with Australian permanent establishments, and
* Australian controllers of controlled foreign entities (and their associates).

However, general class investors do not include a ‘financial entity’ (as defined in the tax law) and authorised-deposit taking institutions (ADIs).

**Exclusions from the new thin cap rules**

A general class investor will be exempt from the new thin cap rules if any of the following exemptions apply:

* The ‘de-minimis’ exemption (where the taxpayer has less than $2 million debt deductions on an associate inclusive basis).
* 90% Australian asset exemption (i.e. outward entity with 90% or more of their assets based in Australia)
* Securitisation vehicle exemption.

The new thin cap rules will also not apply to Australian plantation forestry entities, which are entities that solely or predominately carry on a business of establishing and tending trees for felling in Australia. This means that the old thin cap rules in Division 820 prior to the introduction of the new thin cap rules will continue to apply to these entities.

**NEW THIN CAP TESTS**

We have provided an outline of the new thin cap test in the table below.

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| Test | Application |
| FRT | The FRT disallows debt deductions to the extent that net debt deductions exceed 30% of tax EBITDA (explained further below).  To the extent that deductions are denied under the FRT, they may be carried forward and claimed in a subsequent income year (up to 15 years) subject to satisfying the relevant loss tests (i.e. continuity of ownership, business continuity test) (being the ‘15-year carry forward rule’). However, the FRT must continue to be applied in future income years for the denied deductions to be carried forward.  Where an’ Australian entity’ (i.e. Australian resident company, Australian resident unit trust, a managed investment trust, or Australian resident partnership) has applied the FRT and its net debt deductions are less than 30% of its tax EBITDA, the excess tax EBITDA can be transferred up the chain to its ‘controlling entity’. The excess tax EBITDA amount is added to its tax EBITDA.  We note that only certain types of entities may be ‘controlling entities’ and excess tax EBITDA can’t be passed up to non-eligible entities, such as discretionary trusts.  The FRT is the default test that will apply unless the taxpayer chooses to apply another method. |
| GRT | The GRT may be used as an alternative to the FRT to permit highly leveraged multinational groups to claim higher debt deductions, based on the relevant financial ratio of the worldwide group.  A choice to apply the GRT can only be made by a general class investor where:   * the entity is a ‘GR group member’ (being, there is a worldwide group and the entity is consolidated in the GR group’s audited consolidated financial statements on a line by line basis) * the ‘GR group’ does not comprise of one entity and * the ‘GR group EDITDA’ is more than zero.   If the GRT is chosen, debt deductions of an entity for an income year exceeding the ratio of the group’s third-party interest expense to its financial EBITDA (based on the audited consolidated financial statements) is disallowed. This is known as the ‘group ratio earnings limit’, which is essentially a group-based EBITDA concept.  This ratio is applied to the tested group entity’s tax EBITDA to determine the maximum amount of debt deductions allowable. The excess debt deductions exceeding the maximum amount under the GRT is disallowed.  There is no ability to carry forward debt deductions denied under the GRT (compared to the FRT) and the taxpayer must elect to apply the GRT. |
| TDPT | The TDPT is available to financial entities and general class investors, which will not disallow any third-party debt interest provided the debt satisfies certain conditions. However, if the TDPT is applied then all other debt deductions (i.e. those not attributable to qualifying third-party debt) will be denied.  The TDPT also allows for conduit financier arrangements, where a group member borrows from an external third party and on lends to another group member. In these cases, the recipient group member can treat the intra-group loan as a third-party debt, provided certain conditions are met. The conditions to access the conduit financier rule are incredibly strict, including the requirement that the cost of the on-lent funds are on the same terms as the ultimate third party loan.  The TDPT will may be beneficial to taxpayers in circumstances where external lenders have adopted a more highly geared position than allowed for under the FRT. |

**Tax EBITDA**

Broadly, tax EBITDA is calculated starting with the entity’s taxable income or loss for the year and disregarding the application of the thin cap rules. The following specific adjustments are then required:

***Add:***

* Net debt deductions for the year
* Division 40 deductions (excluding immediately deductible expenses)
* Division 43 claims
* For specific types of entities, the excess tax EBITDA amount transferred from at least 50% controlled entities (noting only specific entities can be controlled)
* General deductions under section 8-1 that relate to forestry and preparation costs and deductions under section 70-120 of the ITAA 1997 (capital costs of acquiring trees)

***Deduct:***

* If the entity is a corporate tax entity that has made a choice under section 36-17 of the ITAA 1997 not to claim all prior year tax losses, the amount of the unclaimed prior year tax losses (ie assume that is has made a choice to utilise all prior year tax losses)
* Notional research and development (R&D) deductions that have been added back in the calculation of taxable income
* Franking credits included in assessable income under Division 207 of the ITAA 1997
* Dividends, trust distributions or partnership distributions received from an ‘associate entity’ (where the entity has a thin capitalisation control interest of 10% or more in the ‘associate entity’)

The result of this calculation is the ‘tax EBITDA’. If it is negative, the tax EBITDA is regarded as being zero.

Where an entity’s net debt deductions are more than 30% of the tax EBITDA, the excess amount is a disallowed tax deduction under the FRT.

Depending on taxpayers’ debt arrangements, they may be able to claim a higher amount of debt deductions under the GRT or TDPT, than what would be available under the default test (being FRT).

As such, it is recommended that taxpayers seek specific advice from their tax advisors on the most appropriate thin cap test to apply for their debt arrangements.

**DEBT DEDUCTION CREATION RULES**

The new debt deduction creation rules will apply to income years commencing on or after 1 July 2024. These rules apply to both pre-existing arrangements and new arrangements after the start date.

The debt deduction creation rules apply to deny debt deductions before applying the above thin cap rules. They apply to all taxpayers subject to the thin cap rules, with the exception of:

* taxpayers who qualify for the ‘de minimus’ exception
* taxpayers who use the TPDT
* taxpayers that use insolvency remote special purpose entities
* securitisation vehicles, or
* ADIs.

Broadly, the debt deduction creation rules may apply to deny deductions on related party debt in the two below cases.

**Asset acquired from an associate**

The first case is where related party related party debt is used to fund the acquisition of a capital gains tax (**CGT**) asset or a legal or equitable obligation from an associate.

The debt deductions are disallowed to the extent that they were incurred in relation to the acquisition, or subsequent holding, of the asset. An example is where assets are acquired by a foreign associate that is vendor financed.

However, the following exceptions apply to assets acquired from associates:

* The acquisition of a newly issued membership interest in an Australian entity or a foreign entity that is a company, which has not previously been held by any entity.
* The acquisition of certain new tangible depreciating assets that are expected to be used for a taxable purpose within Australia within 12 months. This exception is broadly intended to allow an entity to bulk-acquire tangible depreciating assets on behalf of its associates.
* The acquisition of certain debt interest is disregarded. This ensures mere related party lending is not caught under the first case of the debt deduction creation rules.

Section 318 of the Income Tax Assessment Act 1936 (ITAA 1936) provides the meaning of an ‘associate’, which broadly determined by the degree of control or interest an entity has in the other entity.

Further, an ‘associate pair’ is a concept introduced in the debt deduction creation rules that modifies the meaning of an associate under section 820-423E of the ITAA 1997.

**Prohibited payment rule**

The second case is where related party debt has been used (in the current and prior years) to pay to an associate:

* a dividend or other profit-like distribution
* a capital return or
* a royalty or similar payment for the use of, or right to use, an asset

Please note that the above list is not an exhaustive list of payments which could be caught by the new rules.

**Anti-avoidance rule**

The debt deduction creation rules also contain a specific anti-avoidance rule that allows the Commissioner to disallow debt deductions where they are satisfied that:

* it is reasonable to conclude that one or more entities entered into or carried out a scheme for the principle purpose of, or for more than one principle purpose that included the purpose of, having the debt deduction creation rules not apply, and
* the scheme has achieved, apart from the specific anti-avoidance rule, that purpose.

If you have further queries on any details contained within this letter or on any other matter, please do not hesitate to contact me on [insert telephone number].

Yours faithfully,

**[Insert partner name]**