
TREASURY LAWS AMENDMENT (MEASURES FOR FUTURE BILLS) BILL
2023: THIN CAPITALISATION INTEREST LIMITATION

EXPOSURE DRAFT EXPLANATORY MEMORANDUM

Glossary

This Explanatory Memorandum uses the following abbreviations and acronyms.

Abbreviation	Definition
ATO	Australian Taxation Office
ADI	Authorised deposit-taking institution
Commissioner	Commissioner of Taxation
FRT	Fixed ratio test
GR	Group ratio
ITAA 1936	<i>Income Tax Assessment Act 1936</i>
ITAA 1997	<i>Income Tax Assessment Act 1997</i>
OECD	Organisation for Economic Cooperation and Development
TAA 1953	<i>Taxation Administration Act 1953</i>

Chapter 1: Strengthening Australia’s thin capitalisation rules

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Outline of chapter

- 1.1 Schedule 1 to the Bill strengthens the thin capitalisation rules in Division 820 of the ITAA 1997. The amendments address risks to the domestic tax base arising from the use of debt deductions, which amount to base erosion or profit shifting arrangements. The amendments introduce new thin capitalisation earnings-based rules for certain entity types, replacing the existing asset-based rules, and establishing a new arm’s length debt test, in the form of an external third party debt test. The Bill also amends the existing thin capitalisation rules as appropriate to ensure Division 820 continues to be fit for purpose. The amendments apply to income years commencing on or after 1 July 2023.

Context of amendments

- 1.2 Excessive interest deductions (or debt deductions) pose a significant risk to Australia’s domestic tax base.

- 1.3 The OECD's base erosion and profit shifting (BEPS) project outlines the problem of using third party, related party, and intragroup debt to generate excessive deductions for interest and other financial payments.¹ In particular, the OECD notes that "the use of third party and related party interest is perhaps one of the simplest of the profit-shifting techniques available in international tax planning. The fluidity and fungibility of money makes it a relatively simple exercise to adjust the mix of debt and equity in a controlled entity."
- 1.4 In the 2022-23 October Budget, the Government announced that it will strengthen Australia's thin capitalisation rules to address risks to the domestic tax base arising from the use of excessive debt deductions. The Government's Budget announcement was informed by the OECD's best practice guidance. The measure will apply to income years commencing on or after 1 July 2023.
- 1.5 The thin capitalisation regime is Australia's current approach to limiting debt deductions. These rules are designed to limit the debt deductions that an entity can claim for tax purposes based on the amount of debt used to finance its operations compared with its level of equity, by restricting the amount of interest deductions a company can have based on its level of assets.
- 1.6 This approach indirectly limits the amount of debt an entity can use to generate allowable interest deduction. The OECD best practice sets out a direct approach to limit the interest expenses an entity can claim.
- 1.7 For certain entities (namely, general class investors), the amendments replace the existing thin capitalisation rules with rules which are in line with those recommended in the OECD best practice guidance. In addition, financial entities (non-ADI) will be subject to the new external third party debt test in place of the former arm's length debt test. Financial entities and ADIs will otherwise continue to be subject to their existing asset-based thin capitalisation safe harbour and worldwide gearing tests. This is because the OECD recognises that the earnings-based tests are unlikely to be effective for these types of entities, partly as they are net lenders and subject to regulatory capital rules.
- 1.8 These amendments align with the OECD best practice guidance, which recommends limiting an entity's deductions for net interest, and payments economically equivalent to interest, to a percentage of the entity's earnings before interest, taxes, depreciation and amortisation (EBITDA). This reflects the view that aligning interest deductions with taxable economic activity is a more robust approach to address base erosion and profit shifting.
- 1.9 The earnings-based tests are supplemented by an external third party debt test, which allows interest expenses to be deducted where those expenses are attributable to genuine third party debt which is used wholly to fund Australian business operations. That is, deductions for related party debt will be entirely

¹ OECD report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update

disallowed under this test. The external third-party debt test replaces the existing arm's length debt test for 'general class investors' and financial entities (non-ADI), as announced in the 2022-23 Budget.

Summary of new law

- 1.10 The Bill introduces new thin capitalisation earnings-based tests for 'general class investors', specifically, a fixed ratio test that replaces the existing safe harbour test, and a group ratio test that replaces the existing worldwide gearing test. In addition, the Bill introduces an external third party debt test for general class investors and financial entities that are not ADIs. The new thin capitalisation rules may disallow all or part of a general class investor's debt deductions for an income year.
- 1.11 The 'general class investor' concept represents a consolidation of the existing 'general' classes of entities, being 'outward investor (general)', 'inward investment vehicle (general)' and 'inward investor (general)'. Entities which previously fell into one of those classes of entities will now fall under the new 'general class investor' definition. This approach simplifies elements of the thin capitalisation regime, while being clear that financial entities and ADIs are not within the scope of that concept.

Fixed ratio test

- 1.12 The fixed ratio test allows an entity to claim net debt deductions up to 30 per cent of its 'tax EBITDA', which is broadly, the entity's taxable income or tax loss adding back deductions for interest, decline in value, capital works and prior year tax losses. This ensures that a portion of an entity's profits remains subject to tax in Australia and cannot be eroded by excessive debt deductions.
- 1.13 Under the fixed ratio test, a special deduction is allowed for debt deductions that were previously disallowed under the fixed ratio test if the entity's net debt deductions are less than 30 per cent of its 'tax EBITDA' for an income year. Debt deductions disallowed over the previous 15 years can be claimed under this special deduction rule.
- 1.14 The special deduction is included as part of the fixed ratio test to address year-on-year earnings volatility concerns for businesses which limit their ability to claim debt deductions depending on their economic performance for an income year.

Group ratio test

- 1.15 The group ratio test can be used as an alternative to the fixed ratio test for more highly leveraged groups. The group ratio test allows an entity in a highly

leveraged group to deduct net debt deductions in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of the worldwide group.

- 1.16 If the group ratio test applies, the amount of debt deductions of an entity for an income year that are disallowed is the amount by which the entity's net debt deductions exceed the entity's group ratio earnings limit for the income year.

External third party debt test

- 1.17 The external third party debt test allows all debt deductions which are attributable to third party debt and that satisfy certain other conditions. This test replaces the arm's length debt test for all entities previously subject to the arm's length debt test.

Comparison of key features of new law and current law

Table 1.1 Comparison of new law and current law

New law	Current law
The 'general class investor' definition is introduced. The definition is a consolidation of the previous general classes of entities.	General class investors are either an 'outward investor (general)', 'inward investment vehicle (general)' or 'inward investor (general)'.
Earnings-based tests (being the fixed ratio test and the group ratio test) disallow an amount of an entity's debt deductions based on the entity's earnings or profits.	The thin capitalisation rules disallow an amount of an entity's debt deductions by reference to the quantum of debt held by the entity relative to its assets.
A fixed ratio test disallows net debt deductions that exceed a specified proportion (30 per cent) of tax EBITDA. The fixed ratio test replaces the safe harbour debt test for all general class investors.	No direct equivalent. Under the safe harbour debt test, debt deductions in excess of 60 per cent of the average value of the entity's Australian assets are disallowed.
A special deduction is allowed in an income year for debt deductions disallowed under the fixed ratio test over the previous 15 years to the extent that the fixed ratio earnings limit (tax EBITDA) of the entity exceeds the entity's net debt deductions for the income year.	No equivalent.

New law	Current law
<p>As an alternative to the fixed ratio test, the group ratio test disallows debt deductions to the extent that the entity’s net debt deductions exceed the group ratio earnings limit for the income year.</p> <p>The group ratio test replaces the worldwide gearing debt test for all general class investors.</p>	<p>No direct equivalent.</p> <p>The worldwide gearing debt test allows an entity’s Australian operations to be geared up to 100 per cent of the gearing of the worldwide group to which the Australian entity belongs.</p>
<p>The external third party debt test disallows all debt deductions which are not attributable to third party debt and that satisfy certain other conditions. This test replaces the arm’s length debt test for <i>all</i> entities previously subject to that test.</p>	<p>The arm’s length debt test disallows debt deductions where the amount of the entity’s debt exceeds the amount of debt that could have been borrowed by an independent party carrying on comparable operations as the Australian entity.</p>

Detailed explanation of new law

New ‘general class investor’ definition

- 1.18 The Bill introduces new thin capitalisation tests for ‘general class investors’. Entities which are general class investors must apply one of the new thin capitalisation tests. The new tests are the fixed ratio test, the group ratio test, and the external third party debt test. Entities which are not general class investors will continue to be subject to the existing thin capitalisation tests, with the exception of the arm’s length debt test which is being replaced by the external third party debt test for all entities previously subject to it.
- 1.19 ‘General class investor’ is a new concept introduced by the Bill. The concept represents a consolidation of the of the existing ‘general’ classes of entities, being ‘outward investor (general)’, ‘inward investment vehicle (general)’ and ‘inward investor (general)’. Entities which previously fell into one of those classes are now intended to fall under the new ‘general class investor’ definition.
- 1.20 An entity is a ‘general class investor’ for an income year provided:
- it is not, for all the year, a financial entity or an ADI that is either an outward or inward investing entity; and
 - on the assumption that the entity were a financial entity, it would be either an outward or inward investing financial entity that is not an ADI

for the income year.

[Schedule 1, items 12 and 50, subsections 820-43(2) and 995-1(1)]

- 1.21 The effect of the definition of 'general class investor' is that the following entities, which are not financial entities or ADIs, will be general class investors:
- an Australian entity that carries on a 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.
- 1.22 Entities which are financial entities or ADIs for all an income year will need to consider if they fall under one of the other classes of entities.
- 1.23 An entity will need to be a financial entity or an ADI for an entire income year to be precluded from being a general class investor for the income year. This is because the thin capitalisation rules that apply to entities which are not general class investors are generally more favourable than the rules which apply to general class investors.

Definition of 'financial entity'

- 1.24 The Bill repeals paragraph (a) of the definition of 'financial entity' in subsection 995-1(1) of the ITAA 1997. Existing paragraph (a) of the definition of 'financial entity' provides that "financial entity, at a particular time, means an entity other than an ADI that is ... a registered corporation under the *Financial Sector (Collection of Data) Act 2001* ...". This is a broad definition and non-ADI corporations can register under that Act for reasons unrelated to income tax. As a result, an increasing number of entities are now purporting (for tax purposes) to be financial entities.
- 1.25 'Financial entities' and ADIs continue to have access to the existing thin capitalisation tests (with the exception of the arm's length debt test, which is being replaced by the external third party debt test for all entities previously subject to it). The existing tests are generally more favourable to taxpayers than the new tests which only apply to general class investors.
- 1.26 This has given rise to integrity concerns that entities which satisfy this broad definition should genuinely be considered financial entities, with access to the generally more favourable taxation treatment. The repeal of paragraph (a) is an integrity measure to ensure the thin capitalisation rules are fit for purpose and that the amendments to introduce the new earnings-based rules are not undermined.
- [Schedule 1, item 49, subsection 995-1(1)]***

New thin capitalisation tests

Application of the new tests

- 1.27 The new thin capitalisation rules may disallow all or part of a general class investor's debt deductions for an income year. The amount of debt deductions disallowed (if any) is determined through the application of one of the new thin capitalisation tests. The new tests are the fixed ratio test, the group ratio test, and the external third party debt test. An entity chooses which test to apply for all of its debt deductions for an income year.
[Schedule 1, item 12, subsection 820-43(1)]

Application of the fixed ratio test

- 1.28 The fixed ratio test is the default test that applies for general class investors that do not make a choice to use either the group ratio test or the external third party debt test. As the default test, the fixed ratio test is expected to apply to the majority of general class investors.

Application of the group ratio test

- 1.29 The group ratio test requires an entity to determine the ratio of its worldwide group's net third party interest expense to the group's EBITDA for an income year. Therefore, the group ratio test is only available if the entity is a member of a relevant worldwide group.
- 1.30 Specifically, a general class investor can only choose to use the group ratio test if it is a member of a 'GR group' and the 'GR group EBTIDA' for the period is not less than zero. A 'GR group', for a period, is the group comprised of the relevant worldwide parent entity and, generally, all other entities in the group. 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. 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'.
[Schedule 1, items 12 and 50, subsections 820-51(2)-(4) and 995-1(1)]
- 1.31 The GR group EBTIDA is relevant to calculating the group ratio earnings limit, which is discussed below from paragraph 1.54. The requirement for the GR group EBTIDA to not be less than zero is necessary to ensure the meaningful application of the group ratio test and 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.

Application of the external third party debt test

- 1.32 General class investors can choose to apply the external third party debt test in relation to an income year. However, general class investors cannot make this choice if:
- the entity has one or more associate entities who are general class investors for the income year; and
 - those associate entities are not exempt from the thin capitalisation rules; and
 - at least one of the associate entities does not make a choice to use the external third party debt test.
- [Schedule 1, item 12, section 820-43(5)]*
- 1.33 The restriction on this choice ensures that general class investors and their associates are not able to structure their affairs in a way that allows them to artificially maximise their tax benefits by applying a combination of different thin capitalisation tests. The restriction effectively requires a general class investor and all of its associate entities to make a mutual choice to use the third party debt test, if any one of those entities wishes to use that test.
- 1.34 A modified definition of 'associate entity' applies for the purposes of the restriction. In determining whether an entity is an associate entity of another entity, the reference in paragraph 820-905(1)(a) of the Act to "an *associate interest of 50% or more" is instead treated as being a reference to "a *TC control interest of 10% or more". 'TC control interest' is defined in 820-815 and its meaning is affected by sections 820-820 to 820- 835.
- [Schedule 1, items 12, subsection 820-61(9)]*
- 1.35 The modified definition of 'associate entity' strengthens the existing definition and helps to ensure that entities cannot structure their affairs in a manner which avoids the application of the definition and, by extension, the restriction.

Procedure of choices

- 1.36 A choice for an income year to use either the group ratio test or the external third party debt test 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 income year and the day the entity is required to lodge its income tax return for the income year.
- 1.37 A choice for an income year cannot be revoked.
- 1.38 The Commissioner may defer the time within which an approved form is required to be given to them (see section 388-55 in Schedule 1 to the TAA 1953).

[Schedule 1, item 12, subsections 820-43(3)-(4), (7)-(8), item 13, subsections 820-85(2A), (2B) and (2C) and item 26, subsections 820-185(2A), (2B) and (2C)]

Operation of the new tests

- 1.39 The amount of debt deductions of an entity for an income year that is disallowed is the amount by which the entity's:
- if the default fixed ratio test applies – *net debt deductions* exceed the entity's 'fixed ratio earnings limit' for the income year; or
 - if the entity has made a choice to use the group ratio test for the income year – *net debt deductions* exceed the entity's 'group ratio earnings limit' for the income year; or
 - if the entity has made a choice to use the external third party debt test for the income year – *debt deductions* exceed the entity's 'external third party earnings limit' for the income year.
- [Schedule 1, item 12, subsection 820-45(1)]*
- 1.40 This approach to disallowing debt deductions is consistent with the OECD best practice guidance in relation to the fixed and group ratio tests. The 'earnings limit' is the absolute cap on the net debt deductions that an entity is entitled to deduct. Debt deductions are denied by the amount by which net debt deductions exceed the relevant earnings limit.
- 1.41 It is important to note that, contrary to the fixed and group ratio tests, the external third party debt test denies debt deductions by the amount by which debt deductions (*not* net debt deductions) exceeds the relevant earnings limit. This approach is taken to ensure that test achieves its policy of effectively denying all debt deductions which are attributable to related party debt.
- 1.42 If one of the new tests operates to disallow all or part of an entity's debt deductions, then each individual debt deduction is disallowed in the same proportion. This approach is broadly consistent with the existing thin capitalisation rules and ensures that entities cannot choose to disallow certain debt deductions in preference to others.

Operation of the fixed ratio test

- 1.43 The fixed ratio test disallows debt deductions to the extent that net debt deductions exceed a specified proportion (30 per cent) of tax EBITDA. This ensures that a portion of an entity's profit remains subject to tax in Australia and cannot be eroded by excessive debt deductions.
- 1.44 If the fixed ratio test applies, the amount of debt deductions of an entity for an income year that is disallowed is the amount by which the entity's net debt

deductions exceed the entity's fixed ratio earnings limit for the income year.
[Schedule 1, item 12, subsection 820-45(2)]

1.45 An entity's 'fixed ratio earnings limit' for an income year is 30 per cent of its tax EBITDA for that income year.

[Schedule 1, items 12 and 56, subsection 820-47(1) and section 995-1]

1.46 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 (disregarding the operation of the thin capitalisation rules and treating 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 decline in value and capital works deductions (if any) for the income year.
- Step 4: Add the sum of each of the entity's deductions for tax losses from earlier income years.

Subject to Step 5, the result of Step 4 is the entity's tax EBITDA for the income year.

- Step 5: If the result of Step 4 is less than zero, treat it as being zero.

[Schedule 1, items 12 and 60, sections 820-49 and 995-1]

1.47 These steps allow for an entity's tax EBITDA to be calculated according to concepts from Australia's income tax system.

1.48 An entity's 'net debt deductions' for an income year is worked out according to the following steps:

- Step 1: Work out the sum of the entity's debt deductions for the income year.
- Step 2: Work out the sum of each amount included in the entity's assessable income for that year that is:
 - interest; or
 - an amount in the nature of interest; or
 - any other amount that is calculated by reference to the time value of money.

- Step 3: Subtract the result of Step 2 from the result of Step 1.

The result of Step 3 is the entity's net debt deductions for an income year.

[Schedule 1, items 12 and 55, subsection 820-45(3) and subsection 995-1(1)]

- 1.49 These steps allow for an entity's net interest expense to be calculated according to concepts from Australia's income tax system. For these purposes, 'interest' is intended to include amounts economically equivalent to interest, as outlined in the OECD best practice guidance.
- 1.50 A special deduction in relation to debt deductions previously disallowed under the fixed ratio test may be available to taxpayers. The special deduction is discussed below from paragraph 1.83.

Operation of the group ratio test

- 1.51 The fixed ratio test does not account for the fact that groups in different sectors may be leveraged differently for genuine commercial reasons. To supplement the operation of the default fixed ratio test and account for more highly leveraged groups, the Bill also introduces a group ratio test.
- 1.52 Broadly put, the group ratio test allows an entity in a highly leveraged group to deduct net interest expenses in excess of the amount permitted under the fixed ratio rule, based on a relevant financial ratio of the worldwide group's profits adding back certain deductions.
- 1.53 If the group ratio test is chosen, the amount of an entity's debt deductions for an income year that are disallowed is the amount by which the entity's net debt deductions exceed the entity's group ratio earnings limit for the income year.
- 1.54 An entity's 'group ratio earnings limit' for an income year is its 'group ratio' for the income year multiplied by its tax EBITDA for the income year.
[Schedule 1, items 12 and 50, subsection 820-47(2) and subsection 995-1(1)]
- 1.55 An entity's 'group ratio' for an income year is calculated by reference to information contained in the audited consolidated 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 audited consolidated financial statements to include amounts akin to interest and to disregard certain payments to associate entities.
[Schedule 1, item 12, subsections 820-53(2)-(4)]
- 1.56 An entity's 'group ratio' for an income year is worked out according to the following steps:
- Step 1: Work out the GR group net third party interest expense of the GR group.
 - Step 2: Work out the GR group EBITDA of the GR group.
 - Step 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.

- Step 4: If the result of Step 2 is zero or less, the entity's group ratio for the income year is zero.

[Schedule 1, items 12 and 50, subsections 820-51(1) and 995-1(1)]

1.57 The 'GR group net third party interest expense' of a GR group for a period is the amount that would be the group's financial statement net third party interest expense if the relevant audited consolidated financial statements were prepared on the basis that the following were treated as interest:

- an amount in the nature of interest;
- any other amount that is calculated by reference to the time value of money.

[Schedule 1, items 12 and 50, subsections 820-53(1) and 995-1(1)]

1.58 Treating those amounts as interest ensures that amounts that are economically equivalent to interest are used to calculate the GR group net third party interest expense.

1.59 The 'financial statement net third party interest expense' of a GR group for a period is the amount disclosed as such in the audited consolidated financial statements for the period, disregarding certain payments made to or by associate entities outside the group. If no such amount is disclosed in the financial statements, then it is the amount of the group's third party interest expenses (disregarding certain payments made to or by associate entities outside the group) reduced by the amount of the group's third party interest income as disclosed in the audited consolidated financial statements for the relevant period.

[Schedule 1, items 12 and 50, subsections 820-53(2), (3) and 995-1(1)]

1.60 To ensure only third party amounts are used in the calculation of net third party interest expense, payments between GR group members and their associate entities that are outside the group are disregarded. For these purposes, the same modified definition of 'associate entity' discussed in paragraph 1.34 above applies. This prevents inappropriate inflation of the group ratio.

[Schedule 1, item 12, subsection 820-53(3)-(5)]

1.61 The 'GR group EBITDA' of a GR group for a period is the sum of the following (as disclosed in the audited consolidated financial statements for the GR group for the period):

- the GR group's net profit (disregarding tax expenses);
- the GR group's adjusted net third party interest expense; and
- the GR group's depreciation and amortisation expenses.

[Schedule 1, items 12 and 50, subsections 820-55(2) and 995-1(1)]

1.62 However, in working out the GR group EBITDA which includes one or more entities with a negative entity EBITDA amount, those negative amounts are disregarded. This ensures the operation of the group ratio test cannot be

exploited by an entity to allow them to claim excessive debt deductions.

[Schedule 1, item 12, subsection 820-55(3)]

1.63 The ‘entity EBITDA’ of an entity for a period is the sum of the following for the period:

- the entity’s net profit (disregarding tax expenses);
- the entity’s adjusted net third party interest expense; and
- the entity’s depreciation and amortisation expenses.

[Schedule 1, item 12 and 48, subsections 820-55(1) and 995-1(1)]

1.64 The ‘adjusted net third party interest expense’ of an entity for a period, is the amount that would be the entity’s net interest expense for the period if the following payments were disregarded:

- a payment made by the entity to an associate entity;
- a payment made by an associate entity to the entity.

[Schedule 1, items 12 and 46, subsections 820-53(4) and 995-1(1)]

1.65 These adjustments ensure only third party amounts are used in the calculation of ‘adjusted net third party interest expense’. For the purposes of the adjustments, the same modified definition of ‘associate entity’ discussed in paragraph 1.34 above applies.

[Schedule 1, item 12, subsections 820-43(6) and 820-53(5)]

Group ratio records

1.66 Entities are required to prepare and keep records of how they worked out their group ratio. Specific record keeping rules are necessary because entities may work out their group ratio using information that is not publicly available, or have made certain adjustments to their calculations on a self-assessment basis.

1.67 The records must contain the particulars that have been taken into account in working out the group ratio and must be sufficient for a reasonable person to understand how the group ratio has been calculated. The entity must prepare the records by the time the entity is due to lodge its income tax return for the income year.

[Schedule 1, item 44, section 820-985]

Operation of the external third party debt test

Overview of the external third party debt test

1.68 The external third party debt test effectively disallows an entity’s debt deductions to the extent that they exceed the entity’s debt deductions attributable to external third party debt and which satisfy certain other conditions. This 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 capital test.

- 1.69 The external third party debt test operates effectively as a credit assessment test, in which an independent commercial lender determines the level and structure of debt finance it is prepared to provide an entity. As the debt finance is provided by an independent third party, it is assumed to satisfy arm's length conditions.
- 1.70 The test is therefore intended to be a simpler and more streamlined test to apply and administer than the former arm's length debt test, which operates based on valuation metrics and the 'hypothesised entity comparison'.
- 1.71 The third-party debt test is designed specifically to be narrow, to accommodate only genuine commercial arrangements relating only to Australian operations and investments.
- 1.72 This is a considered design approach and is not intended to accommodate all debt financing arrangements that may be accepted as current practice within industry.
- 1.73 In this regard, the external third party debt test balances delicately the tax integrity policy intent and the need to ensure genuine commercial arrangements are not unduly impeded.

Operation of the external third party debt test

- 1.74 If the external 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 external third party earnings limit for the income year.
- 1.75 An entity's 'external 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 external third-party debt conditions in relation to the income year. For the purposes of the external third party earnings limit, 'debt interest' takes its meaning as defined in Subdivision 974-B of the ITAA 1997.
- [Schedule 1, items 12 and 48, subsections 820-61(1) and 995-1(1)]***
- 1.76 A debt interest issued by an entity satisfies the 'external third-party debt conditions' in relation to an income year if the following conditions are satisfied:
- the entity issued the debt interest to an entity that is not an associate entity of the entity;
 - the debt interest is not held at any time in the income year by an entity that is an associate entity of the entity;
 - the holder of the debt interest has recourse for payment of the debt only to the assets of the entity; and

- the entity uses the proceeds of issuing the debt interest wholly to fund:
 - its investments that relate only to assets that are attributable to the entity’s Australian permanent establishments or that the entity holds for the purposes of producing assessable income; and
 - its Australian operations.

[Schedule 1, items 12 and 48, subsections 820-61(2), (3) and 995-1(1)]

1.77 These conditions aim to ensure the external third party debt test only captures genuine third party debt which is used wholly to fund Australian business operations (as opposed to offshore business operations).

[Schedule 1, item 12, section 820-61(3)]

1.78 Additional rules allow conduit financier arrangements to satisfy the external third party debt conditions in certain circumstances. Conduit financier arrangements are relatively common commercial arrangements which are generally implemented to allow one entity in a group to raise funds on behalf of other entities in the group. This can streamline and simplify borrowing processes for the group.

1.79 In the context of the external third party debt test, conduit financier arrangements exist where an entity (a ‘conduit financier’) issues a debt interest to another entity (an ‘ultimate lender’) and that debt interest satisfies the external third party debt conditions. The conduit financier then on-lends the proceeds of that debt interest to one or more associate entities on the same terms as the debt interest issued to the ultimate lender.

[Schedule 1, item 12, subsection 820-61(4) and paragraphs 820-61(5)(a)-(f)]

1.80 Broadly put, the debt interest that the associate entities (the ‘ultimate borrowers’) issue to the conduit financier (the relevant debt interest) will satisfy the external third-party debt conditions if the following conditions are satisfied:

- the conduit financier financed the amount loaned under the relevant debt interest only with proceeds from another debt interest (the ‘ultimate debt interest’);
- the conduit financier issued the ultimate debt interest to another entity (the ultimate lender);
- the ultimate debt interest satisfies the external third party debt conditions in relation to any income year (or would satisfy the conditions if paragraph 820-61(2)(c) were disregarded);
- the terms of the relevant debt interest are the same as the terms of the ultimate debt interest (other than terms as to the amount of the debt, the conduit financier may on-lend the funds across a number of borrowers in the group);

- the ultimate lender has recourse for payment of the ultimate debt interest *only* to the assets of the ultimate borrowers and each asset of the conduit financier that is a relevant debt interest; and
- an irrevocable choice has been made, in the approved form, by the conduit financier and ultimate borrowers.

[Schedule 1, item 12, subsections 820-61(4)-(8)]

- 1.81 The requirement for the terms of the relevant debt interest to be on the same terms as the terms of the ultimate debt interest is intended to ensure that conduit finance arrangements that satisfy these criteria, are afforded the same tax treatment as if the finance had been provided directly to the ultimate borrowers.
- 1.82 To ensure the external third party debt conditions are effective and cannot be readily avoided, the same modified definition of associate entity discussed in paragraph 1.34 above applies.
- [Schedule 1, items 12, subsection 820-61(9)]*

Special 15-year carry-forward deduction for the fixed ratio test

- 1.83 A special deduction for debt deductions disallowed under the fixed ratio test over the previous 15 years is available to general class investors in certain circumstances.
- 1.84 The special deduction available as part of the fixed ratio test addresses year-on-year earnings volatility concerns for businesses which are limited in their ability to claim debt deductions depending on their economic situation. The carry forward rule also accommodates entities with initial periods of high upfront capital investment relative to their initial income or which incur interest expenses on long-term investments that are expected to generate taxable income only in later years. Such entities may be start-ups, tech firms and greenfield investments.
- 1.85 The special 15-year carry-forward deduction allows entities to claim debt deductions that have been previously disallowed within the past 15 years under the fixed ratio test when they are sufficiently profitable in an income year if their fixed ratio earnings limit exceeds their net debt deductions in the income year.
- 1.86 The 15-year period is introduced to limit the tax benefit of disallowed amounts to a defined period. This reduces the impact of debt deductions being permanently disallowed and allows for the level of an entity's net debt deductions to be linked to its earnings over time.
- 1.87 For the special deduction to apply, the entity must be using the fixed ratio test for the income year and its fixed ratio earnings limit for the income year must exceed its net debt deductions. An amount of those previously disallowed debt deductions up to this excess may be able to be deducted, subject to satisfying

further criteria. If net debt deductions are equal to or higher than the fixed ratio earnings limit, then no previously disallowed debt deductions can be deducted.
[Schedule 1, item 12, subsection 820-57(1)]

- 1.88 The amount of the deduction for an income year is worked out according to the following steps:
- Step 1: Work out the amount by which the entity's fixed ratio earnings limit exceeds its net debt deductions for the income year.
 - **Step 2 (the apply against excess step):** Apply against that excess each of the entity's fixed ratio test (FRT) disallowed amounts for the previous 15 income years (to the extent that they have not already been applied under this step in a previous income year).
 - Step 3: The amount of the deduction is the total amount applied under Step 2.
[Schedule 1, item 12, subsection 820-57(2)]
- 1.89 An entity has a 'fixed ratio test disallowed amount' (or 'FRT disallowed amount') for an income year equal to the debt deductions of the entity for the income year that are disallowed under the fixed ratio test for that income year.
[Schedule 1, items 12 and 50, subsections 820-59(1) and 995-1(1)]
- 1.90 If an entity uses the fixed ratio test in an income year and does not use the fixed ratio test in a subsequent income year, the entity loses the ability to carry forward any existing FRT disallowed amounts for income years going forward. Entities must continue to use the fixed ratio test every income year to maintain access to their current carried forward FRT disallowed amounts.
[Schedule 1, item 12, subsections 820-59(2) and (3)]
- 1.91 FRT disallowed amounts must be applied in sequence, such that FRT disallowed amounts attributable to the earliest income year, subject to the 15-year limit, are applied first.
[Schedule 1, item 12, subsection 820-57(3)]

Modified COT for FRT disallowed amounts

- 1.92 If an entity is a company, then they must pass a modified version of the continuity of ownership test (COT) in relation to each of their FRT disallowed amounts they are seeking to apply under Step 2 (the apply against excess step). If the modified COT is not passed in relation to an FRT disallowed amount, the entity cannot apply the amount under Step 2.
- 1.93 In line with the policy objective of the COT relevant for carried-forward company tax losses in section 165-12 of the ITAA 1997, the modified COT ensures that a company can only deduct an FRT disallowed amount where it has maintained a majority of the same owners since those amounts were disallowed.

- 1.94 The modified COT prevents an FRT disallowed amount from being applied under Step 2 (the apply against excess step) unless (based on certain modifications):
- the company maintains the same owners per the conditions in section 165-12 of the ITAA 1997 and
 - the same people control the voting power of the company per the conditions in one or more of paragraphs 165-15(1)(a), (b) and (c) of the ITAA 1997.

[Schedule 1, item 12, subsections 820-59(4)-(8)]

- 1.95 To adapt the legislative conditions listed in the above paragraph to FRT disallowed amounts, certain modifications are made for the purposes for determining whether the legislative conditions are satisfied:

- treat the FRT disallowed amount as the company's tax loss;
- treat the disallowance year as the loss year;
- treat the period from the start of the disallowance year to the end of the deduction year as the ownership test period;
- disregard the following provisions:
 - subsection 165-12(1) (this subsection defines 'ownership test period');
 - subsection 165-115B(3) (this subsection concerns a net capital loss);
 - subsection 415-35(3) (this subsection contains a special rule for designated infrastructure project entities).

[Schedule 1, item 12, subsection 820-59(7)]

- 1.96 In applying the modified COT, Divisions 165, 166 and 167 of the ITAA 1997 are intended to apply.

[Schedule 1, item 12, subsection 820-59(8)]

- 1.97 Division 165 concerns whether a company can deduct its tax losses of earlier income years. Division 166 modifies the way the rules in Division 165 apply to a widely held or eligible Division 166 company by making it easier for the company to apply the rules. Division 167 modifies the way conditions relating to Part 3-5 (which includes Divisions 165, 166 and 167) apply to companies whose shares do not all carry the same rights to dividends or capital distributions or do not all carry the same voting rights, or do not carry all the voting rights in the company.

The special deduction and consolidated groups

- 1.98 To align with the tax consolidation rules that allow the transfer of tax losses into a tax consolidated group when an entity joins the group and limits the rate

at which those losses can be utilised, the FRT disallowed amounts may also be transferred to and utilised by the head company of a tax consolidated group.

1.99 When an entity with an FRT disallowed amount joins a tax consolidated group, that FRT disallowed amount is transferred to the head company of that group at the joining time. This transfer occurs even where the joining entity becomes the head company of the tax consolidated group at the joining time.

[Schedule 1, item 43, subsections 820-62(1), (2) and (3)]

1.100 However, the FRT disallowed amount is transferred only to the extent (if any) that the FRT disallowed amount could have been applied by the joining entity under Step 2 (the apply against excess step) in respect of an income year (the trial year). The trial year is generally the period commencing 12 months before the joining time to just after the joining time).

1.101 Specifically, the FRT disallowed amount is transferred at the joining time from the joining entity to the head company if:

- at the joining time, the joining entity had not become a member of the joined group (but had been a wholly-owned subsidiary of the head company if the joining entity is not the head company); and
- the amount applied by the joining entity under Step 2 (the apply against excess step) in respect of the trial year were not limited by the joining entity's excess.

[Schedule 1, item 43, subsections 820-62(2)-(6)]

1.102 If an FRT disallowed amount cannot be transferred, then the amount is effectively lost and cannot be applied under Step 2 (the apply against excess step) by any entity.

[Schedule 1, item 43, subsection 820-62(8)]

1.103 The rules outlined above aim to ensure that FRT disallowed amounts can only be transferred if the joining entity is able to apply the FRT disallowed amounts under Step 2 (the apply against excess step). Otherwise, taxpayers may be able to circumvent the policy and rules relating to FRT disallowed amounts through the consolidation process.

1.104 If a FRT disallowed amount is successfully transferred, then the head company is treated as having that amount for the same income year in which the joining entity had the amount. This preserves the effect of the 15-year carry forward rule.

[Schedule 1, item 43, paragraph 820-62(1)(b) and subsection 820-62(3)]

1.105 However, for the purposes of applying the modified COT, the head company is treated as acquiring FRT disallowed amounts at the joining time. This rule is similar to that provided by existing section 707-140 of the ITAA 1997 in relation to tax losses and is necessary to ensure the modified COT is not automatically failed for income years occurring after consolidation.

[Schedule 1, item 43, subsection 820-62(7)]

- 1.106 When a tax consolidated group forms, or one or more entities join a tax consolidated group, tax costs for the assets of each joining entity are calculated by reference to the allocable cost amount (ACA) for the joining entity. The ACA is essentially the sum of the cost base of membership interests in the joining entity and the joining entity's liabilities and certain profits. The cost base of the membership interests in the joining entity is effectively transferred to the assets of that entity. The ACA is generally allocated to the assets the subsidiary brings into the group in proportion to their market values.
- 1.107 On exit from the group, the process is reversed and the group's cost base of the equity in the leaving entity is derived from the net assets of the leaving entity at the designated time.
[Schedule 1, item 12, section 820-63]
- 1.108 A new step is added to the how the ACA of a joining entity is worked out under existing section 705-60 of the Act. New step 6A requires taxpayers to subtract from the result of step 6 the step 6A amount worked out under section 705-112.
[Schedule 1, items 3 and 4, table items 6 and 7 in section 705-60]
- 1.109 The purposes of new step 6A is to stop the joined group getting benefits both through higher tax cost setting amounts for the joining entity's assets and through FRT disallowed amounts transferred to the head company. This is similar to purpose of step 6, which is about tax losses.
- 1.110 Whilst it may not technically be a certainty that a head company will be able to utilise a transferred FRT disallowed amount, it is expected that the head company will generally be able to utilise the FRT disallowed amounts, hence the addition of step 6A.
- 1.111 The step 6A amount worked out under new section 705-112 is worked out by multiplying the sum of the transferred FRT disallowed amounts by the corporate tax rate. The transferred FRT disallowed amounts are the joining entity's FRT disallowed amounts that are transferred to the head company, to the extent that they have not already been applied by the joining entity.
[Schedule 1, item 5, section 705-112]

Exemptions to the thin capitalisation rules

- 1.112 Section 820-37 of the ITAA 1997 currently provides an exemption to the thin capitalisation rules for outward investing entities in certain circumstances.
- 1.113 With the introduction of the new 'general class investor' concept, section 820-37 is amended to ensure it continues to apply to outward investing entities and now applies to general class investors who, assuming those general class investors were financial entities, would be an outward investing financial entity (non-ADI).
[Schedule 1, item 8, paragraph 820-37(1)(a)]

- 1.114 These amendments maintain the policy intention of providing an exemption from the thin capitalisation rules for outward investing entities in certain circumstances.
- 1.115 Section 820-35 of the ITAA 1997 currently provides an exemption from the thin capitalisation rules for an entity if the total debt deductions of that entity and all its associate entities for an income year are \$2 million or less. Minor amendments are made to this section to ensure it includes the new thin capitalisation rules set out in new subdivision 820-AA. However, the \$2 million or less threshold is unchanged.
[Schedule 1, item 7, section 820-35]

Definition of ‘debt deduction’

- 1.116 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 best practice guidance.
- 1.117 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. This change means that amounts which are economically equivalent to interest, but which may not necessarily be incurred in relation to a debt interest issued by the entity, fall within the definition of debt deductions.
[Schedule 1, items 9-11, subsection 820-40(1)]

Removing the deduction for 768-5 NANE income

- 1.118 Section 768-5 of the ITAA 1997 deems certain foreign equity distributions as non-assessable non-exempt (NANE) income of an entity. At the same time, sections 25-90 and 230-15 of the ITAA 1997 provide that interest expenses incurred to derive this NANE income are deductible. This is contrary to the general rule in Australia’s tax system which provides that expenses incurred in deriving NANE income are non-deductible.
- 1.119 Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings – that is, an entity is only able to increase its net interest deductions in Australia by increasing earnings in Australia. The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income.
- 1.120 To address this double benefit and ensure the effectiveness of the thin capitalisation rules, sections 25-90 and 230-15 are amended so that they do not allow a deduction for interest expenses incurred to derive the NANE income

under section 768-5.

[Schedule 1, items 1 and 2, paragraphs 25-90(b) and 230-15(3)(c)]

'Associate entity' – complying superannuation fund exemption

- 1.121 The definition of 'associate entity' in section 820-905 of the ITAA 1997 can operate too broadly in relation to superannuation funds and inappropriately restrict their ability to borrow. The associate entity rules were introduced at a point when the Australian superannuation sector was in a relatively early stage.
- 1.122 In the intervening period, superannuation funds have grown to have significant investments in a variety of different assets and are now an important source of capital investment for Australian assets, particularly infrastructure assets. Under the current rules, these investments may cause superannuation funds to have a relatively large number of associate entities, which would bring their investments into scope of the thin capitalisation rules. However, superannuation funds are subject to a relatively strong regulatory regime and generally do not exercise any meaningful control over their associate entities. On this basis, the associate entity definition (to the extent it relates to the thin capitalisation rules) is no longer fit-for-purpose for Australian superannuation funds.
- 1.123 To address this issue, the definition of 'associate entity' in section 820-905 is amended so that it does not apply to a trustee of a complying superannuation entity (other than a self-managed superannuation fund).
[Schedule 1, item 45, subsection 820-905(1)]

Consequential amendments

- 1.124 Section 815-140 of the ITAA 1997 makes modifications to certain transfer pricing rules in Division 815 where the arm's length conditions have operated to affect costs that are debt deductions may operate to the application of
- 1.125 The existing thin capitalisation rules operate to determine an amount of maximum allowable debt. Broadly, this is amount of debt that an entity can have before it is considered to be thinly capitalised and debt deductions are disallowed.
- 1.126 As debt deductions are disallowed on a quantum of debt basis in existing Division 820, it was not necessary for the arm's length conditions in Division 815 to also seek to do this. Section 815-140 effectively disappplied the arm's length conditions in relation to the quantum of the debt interest.
- 1.127 However, as the new thin capitalisation tests deny debt deductions on an earnings basis, the arm's length conditions should not be disappplied for entities using the new earnings-based tests. Consequential amendments are made to

ensure this outcome.

[Schedule 1, item 6, section 815-140]

General class investor consequential amendments

1.128 In line with the consolidated approach to group general investors, references to the definitions of ‘outward investor (general)’, ‘inward investor (general)’ and ‘inward investment vehicle (general)’ throughout Division 820 and the section 995-1 have been removed.

[Schedule 1, items 14, 17, subsections 820-90(1) and (2), items 27, 28, paragraphs 820-185(3)(a) and (b), items 38, 39, section 820-225(2) paragraphs (a) and (b) of step 2 of the method statement, items, 51, 54, 58 subsection 995-1(1)]

Fixed ratio test consequential amendments

1.129 The safe harbour debt test is no longer an option for general class entities as the fixed ratio test is the replacement test. Accordingly, provisions relating to the safe harbour debt test are repealed.

[Schedule 1, items 20, 31, 32, 59 sections 820-95, 820-195, 820-205 and subsection 995-1(1)]

Group ratio test consequential amendments

1.130 The worldwide gearing debt test is no longer an option for general class investors as the group ratio test replaces it. Definitions and other provisions have been amended accordingly.

[Schedule 1, items 22 and 23, subsections 820-110(1) and 820-111(1), and items 34, 35, 61, sections 820-216, 820-218 and subsection 995-1(1)]

External third party debt test consequential amendments

1.131 The respective provisions for inward and outward investing (non-ADI) entities have been updated to reflect the disallowed debt deduction that arises from applying the external third party debt test and the corresponding calculation of the disallowed amount that is worked out by disallowing each debt deduction on a proportionate basis.

[Schedule 1, item 13, subsections 820-85(1), (1A) and (2), items 24 and 25, subsections 820-115(1)-(3), item 26, 820-185(1A), (1) and (2) and items 36 and 37, subsections 820-220(1)-(3)]

1.132 Consequential amendments are made to paragraph 820-583(3)(a) to reflect the updated table items in subsection 820-85(2). Similarly, paragraph 820-583(3)(b) is now redundant given that the head company needs to be a financial entity throughout the period.

[Schedule 1, items 40-42, subsections 820-583(1)-(4)]

1.133 The introduction of the external third party debt test results in references to the arm’s length debt test being removed and the inclusion of notes that

differentiate between general class investors and financial entities.
[Schedule 1, items 15, 16, 18, 19, subsections 820-90(1) and (2), item 21, section 820-105, items 29, 30, section 820-190(1) item 33, sections 820-215 and items 52, 53, 56 and 57, subsection 995-1(1)]

Commencement and application provisions

- 1.134 Schedule 1 to the Bill commences on the first 1 January, 1 April, 1 July or 1 October after the Bill receives Royal Assent.
- 1.135 The amendments apply in relation to income years commencing on or after 1 July 2023.
[Schedule 1, item 62]