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# Legislation introduced for new Australian interest limitation rules

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*With the bill implementing changes to the interest limitation / thin capitalisation rules now in Parliament and a 1 July 2023 start date for many groups, taxpayers will need to act quickly to assess the impacts.*

The bill has been referred to the Senate Economics Legislation Committee, which is due to report back on 31 August 2023. The consultation period for the bill closes 21 July 2023.

This legislation primarily modifies the thin capitalisation rules. Please see our previous article for additional background in relation to the thin capitalisation rules and the previous exposure draft legislation.

The rules included in the legislation are broadly consistent with exposure draft legislation, although there have been some important changes. We outline these below.

The rules will apply for income years beginning on or after 1 July 2023. The new interest limitation rules broadly apply to non-financial entities, although the bill includes key amendments that are applicable beyond this group.

## Deductions relating to foreign income

The exposure draft included a major change, not previously foreshadowed by the government, to deny interest deductions on borrowings to fund equity investments in foreign subsidiaries (under sections 25-90 and 230-15 of the *Income Tax Assessment Act 1997*). Following stakeholder feedback, this proposal has been deferred. The explanatory memorandum (EM) notes that the proposal will be considered via a separate process.

## Debt deduction creation schemes

In place of the changes to section 25-90, the bill includes new rules not previously foreshadowed by the government targeting circumstances where interest-bearing debt is created within a multinational group. The in-scope arrangements broadly involve either:

- An entity acquiring an asset (or an obligation) from an associate, with the entity, or one of its associates, incurring debt deductions in relation to the acquisition of that asset. The debt deductions are disallowed to the extent that they are incurred in relation to the acquisition, or subsequent holding, of the asset; or
- An entity borrowing from its associate to fund a payment to that, or another, associate, with the entity incurring debt deductions in relation to the borrowing. The debt deductions are disallowed to the extent that they are incurred in relation to the borrowing.

These new rules potentially have very broad application and must be considered in the context of existing or planned arrangements involving debt with related parties. Importantly, the absence of any grandfathering rules means that taxpayers will have to consider whether any existing debt arrangements funded such transactions in the past.

The new debt deduction creation rule applies to all taxpayers within scope of the thin capitalisation rules, including financial entities and ADIs as well as those for whom the exemptions (other than the de minimis exception for debt deductions not exceeding AUD 2 million) would otherwise switch off the provisions.

## Fixed ratio test (FRT)

The key aspects of the FRT are consistent with the draft legislation, namely that it is a taxpayer-by-taxpayer test that limits net debt deductions to 30 percent of tax EBITDA.

There are some changes that will be welcomed by taxpayers, particularly a broadening of the tax depreciation addback (i.e. the 'DA' in tax EBITDA) to include all Division 40 and 43 depreciation, except where there is an immediate deduction for the entire expense under those divisions. This should simplify the work required for this component of the computation.

New adjustments to the tax EBITDA computation are now required in respect of income received from other entities, i.e. dividends, and distributions from non-portfolio interests in partnerships and trusts. These adjustments prevent the duplication of capacity that would otherwise result by these distributions being included in taxable income.

On the other hand, there is still an absence of provisions allowing the sharing or grouping of excess borrowing capacity. This will be an important consideration for corporate groups that are not tax consolidated for Australian tax purposes as well as trust structures. For example, where a holding trust has external lending, and its downstream trusts hold property assets, the holding trust cannot include the downstream capacity in its FRT computation.

Finally, carried forward tax losses are no longer an addback in the tax EBITDA calculation. This will result in higher interest deductions being denied due to lower tax EBITDA where carried forward losses are being utilised and will effectively result in the carried forward tax losses being recycled into carried forward denied deductions.

## Carry forward of denied deductions and the special deduction

In certain circumstances, debt deductions denied under the FRT can be carried forward and recouped in a future year when there is excess capacity. The 15-year carry forward period has been retained. While the draft legislation included the requirement to satisfy a modified version of the continuity of ownership test (for companies only), this has been extended to include the business continuity test. Recoupment tests have also been added for trusts (leveraging the trust loss recoupment rules) but not for partnerships.

In order to claim the special deduction in a future year, the rules continue to require that a taxpayer does not make a choice to use the GRT or third-party debt test in the intervening period.

## Group ratio test (GRT)

This test is largely consistent with the draft legislation. It 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, with this ratio multiplied by the entity's tax EBITDA to calculate an allowable amount of debt deductions.

The definition of a 'GR group' has been extended to include groups where global financial statements are prepared for the global parent and the other entities that are fully consolidated on a line-by-line basis in those financial statements (in addition to groups where the parent prepares audited consolidated financial statement).

There are a number of complexities with this calculation, including needing to adjust net interest expense for payments of interest to and from 20 percent associates and exclude from the Group EBITDA any entity that, on a standalone basis, has a negative EBITDA.

## Third party debt test

This test allows debt deductions to the extent that they are attributable to debt that satisfies the 'third party debt conditions'.

The draft legislation included a mutual choice condition, requiring all associate entities (using a 10 percent threshold) to make the same election to apply this test in that income year. This has been refocused, such that once the borrower makes the choice to apply this test, the other members of its obligor group (or cross-staple arrangement) are deemed to have made the same choice.

While this test is still narrow in operation, changes to the conditions have been made following the consultation process. In particular, the test now requires that the lender has recourse for payment only to Australian assets held by the borrower that are not rights in relation to a guarantee, security or other form of credit support (e.g. parent guarantees may preclude reliance on this test). However, there is an exception broadly in circumstances where the taxpayer is involved in the creation or development of real property (e.g. equity commitment letter).

## Conduit financer exception

This is a concession to allow certain on-lending arrangements (‘conduit financer arrangements’) to satisfy the third party debt test. While the draft legislation required that the conduit financer on-lend on the same terms as the ultimate borrowing, this has now been modified. The test now states that the terms must be the same, to the extent that those terms relate to a cost incurred in relation to the debt. However, this condition disregard terms such as those which have the effect of allowing the recovery of reasonable administrative costs. The bill now clarifies that the conduit financer must also be an Australian resident and an associate of the borrower.

**Other aspects of the legislation**

- The definition of ‘debt deductions’ (relevant to determining what type of deductions are disallowed under the interest limitation rules) has changed, and a reduction mechanism to that item for certain interest income is introduced (new item called ‘net debt deductions’). Notably, the definition now includes an amount that is economically equivalent to interest, which is aligned to the OECD's best practice guidelines.
- The changes in the draft legislation relating to transfer pricing have been retained. This means that the ‘arm’s length conditions’ requirement under Australia’s transfer pricing rules must be satisfied in relation to the quantum and pricing, and hence the transfer pricing rules could further limit the amount of deductible debt. This is likely to significantly alter the transfer pricing analysis needed when assessing financing options.
- The existing exceptions (i.e. de minimis exception for debt deductions not exceeding AUD 2 million, securitisation vehicle exception and the exception for Australian based groups with Australian assets not exceeding 90 percent) all remain but importantly only the first applies to exclude taxpayers from the operation of the new debt deduction creation rule.
- The change to the definition of financial entity that was in the ED has been relaxed somewhat. Entities registered under the *Financial Sector (Collection of Data) Act 2001* remain financial entities provided they are not providing finance to or on behalf of associates and they derive all or substantially all of their profits from the business of providing finance.
- Complying superannuation funds and their wholly owned subsidiaries are carved out from the ‘associate entity’ definition, so that their domestic portfolio investments are not subject to thin capitalisation rules.

With the new rules having now commenced, businesses should take immediate action to prepare for the impact of these changes on existing and future arrangements.

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