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Limiting debt deductions: a look at the new thin capitalisation regime

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1. Introduction

In 2022, the then newly elected Australian Labor Government published a Consultation Paper in which it confirmed that it would undertake the ambiguous (and unenviable) task of comprehensively reviewing Australia's interest limitation – or thin capitalisation – regime. The thin capitalisation regime is Australia's method of limiting debt deductions otherwise available to an entity where the entity is too highly leveraged and, therefore, 'thinly capitalised'.

The thin capitalisation amendments ultimately passed by the Government are expected to limit debt deductions for taxpayers broadly in line with the approach recommended by the OECD, by shifting the focus for most taxpayers from an assets-based test to a profits-based test. Although the changes may be welcome for those entities with high profit margins, they are likely to reduce the quantum of debt deductions available for many entities, particularly those which have relatively low, stable returns, such as infrastructure assets.

At the same time as revamping Australia's thin capitalisation rules, the Government has introduced a new integrity measure to disallow debt deductions for certain 'debt deduction creation' schemes. The Government had originally proposed a sweeping new integrity rule – one without any prior notice, and of alarming breadth – but ultimately heeded to a chorus of industry criticism by enacting a rule which is more targeted but remains capable of broad application.

In this paper, we start by examining the global context for the changes in **Section 2** and provide a brief history of Australia's interest limitation rules in **Section 3**. We then summarise some of the key features of the new thin capitalisation rules in **Sections 4 to 8**. In **Section 9**, we briefly consider the related changes to Australia's transfer pricing regime, and in **Section 10**, the new debt deduction creation rule – or the ***DDCR***.

This paper is not intended to be a detailed or comprehensive account of the new rules, or to chronicle the various iterations of the rules as they were developed through the different consultation processes. Rather, in this paper, we summarise some key aspects of the rules and outline some of the practical difficulties that we anticipate taxpayers may face with their application. We expect further technical amendments will be required to clarify various aspects of the rules, and the practical application of the rules will, no doubt, be informed by forthcoming ATO guidance.

Overall these new measures represent a wholesale change to Australia's interest limitation regime and are part of the Government's broader policy agenda of ensuring multinational enterprises (including those based in Australia) are paying their fair share of tax in Australia. It is likely that the overall effect of the measures, including their potential impact on Australia's attractiveness for foreign investment, will not be fully understood for some time.

2. The global context

Following a suite of work undertaken by the Organisation for Economic Cooperation and Development (***OECD***) and the G20, governments around the world – including the United Kingdom, the United States and Canada – have been making adjustments to their interest limitation rules to align with Action 4 of the OECD's Base Erosion and Profit Shifting (***BEPS***) Program.[1]

In September 2013, the OECD and G20 countries adopted the *Action Plan on Base Erosion and Profit Shifting*, containing 15 'actions' or 'points' which were intended to address BEPS, following the release of the *Addressing Base Erosion and Profit Shifting* in July 2013. The OECD and the G20 have since been working through this Action Plan, including Action 4 which related to base erosion through the use of interest deductions and other financial payments:[2]

> **Action 4 Limit base erosion via interest deductions and other financial payments**
>
> Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments. The work will evaluate the effectiveness of different types of limitations. In connection with and in support of the foregoing work, transfer pricing guidance will also be developed regarding the pricing of related party financial transactions, including financial and performance guarantees, derivatives (including internal derivatives used in intra-bank dealings), and captive and other insurance arrangements. The work will be co-ordinated with the work on hybrids and CFC rules.

Action 4 was necessary to address base erosion occurring due to the difference in tax rates between different jurisdictions around the world which had the potential to result in multinational groups preferring higher levels of debt in those jurisdictions with higher tax rates (such as Australia).

In 2015, the OECD and G20 released a joint report on Action Item 4 – *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments* – outlining several best practices and a recommended approach to address the risks identified in Action 4 (the ***Action 4 Report***). This recommended approach is based on implementing an earnings-based interest limitation regime, which broadly limits an entity's net debt deductions to a percentage of earnings before interest, taxes, depreciation and amortisation (***EBITDA***). An earnings-based test is seen to create a stronger link between the generation of taxable income and the allowance of debt deductions.

The Action 4 Report, however, also recognised that there would be alternative approaches for taxpayers in highly leveraged groups (referred to as the group or worldwide ratio rule) and that certain sectors, such as the banking and insurance sector, would need to have separate and specific rules. These alternative approaches were subject to a separate report released by the OECD in 2016.[3]

The OECD and G20 also recognised that the transfer pricing rules would need to be reconsidered, given these apply to intragroup debt. Revisions to the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* were, therefore, released in 2017, and again in 2022.[4]

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[1] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - Final Report* dated October 2015.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting,* July 2013, page 17.

[3] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2016 Update* dated December 2016.

[4] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, July 2017; OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* dated January 2022.

3. A brief history of Australia's thin cap rules

Before considering the new thin capitalisation rules, it is worth briefly outlining their history.

3.1 The rules before Division 820

Australia's first targeted interest limitation rules were introduced in the late 1980s into former Division 16F of the *Income Tax Assessment Act 1936* (Cth) (the ***1936 Act***).[5] These rules were narrow and were targeted at foreign related-party debt. They were thought to be deficient in two key respects. First, they only applied to foreign controlled Australian operations and non-resident deriving Australian assessable income. And second, they only limited debt borrowed from a foreign controller or other foreign related parties, and (in the case of companies) third party debt guaranteed by a related party.[6] Accordingly, they did not provide coverage for all types of debt of an entity. There was a concern, therefore, that multinational groups could choose to leverage their Australian operations disproportionately to the gearing of their global group.

These rules were supplemented by former Div 16G of the 1936 Act which broadly applied to cross-border corporate restructures to ensure that an Australian entity was not able to obtain increased tax deductions as a result of a restructure involving a foreign element.[7] Former Division 16G is discussed further in **Section 10** below.

3.2 The 'former' Division 820, for most entities

In 2001, Division 820[8] was introduced into the *Income Tax Assessment Act 1997* (Cth) (the ***1997 Act***[9]*)*, replacing former Division 16F. Under Division 820, debt deductions (eg, for interest expenses) are disallowed to the extent a relevant taxpayer exceeds certain prescribed debt limits based on, generally, asset-based testing.

Under Division 820, prior to the modifications introduced earlier this year, the standard **safe harbour rule** – which was relied on by most taxpayers[10] – provided that taxpayers could claim debt deductions up to, broadly, a debt-to-equity ratio of 1.5:1 (or 60%, noting that until 2014 this was 75%). Alternative safe harbour regulations existed for authorised deposit-taking institutions (***ADIs***) and other non-ADI financial entities. Additionally, a **worldwide gearing test** allowed for interest deductions on debt up to, broadly, the same percentage as the global group's gearing ratio under certain conditions.

Division 820 also included an **arm's length debt test** (***ALDT***) which allowed a taxpayer to claim debt deductions based on the quantum of debt that would, broadly, be deemed reasonable if it were borrowed under an arm's length transaction. This meant that a taxpayer could potentially go beyond the asset-based safe harbour or the worldwide gearing ratio if they were able to demonstrate that the borrowing did not exceed the amount of debt the taxpayer would reasonably be expected to have borrowed, and the amount of debt that would reasonably be expected to have been provided to the

[5] As introduced by *Taxation Laws Amendment Act (No 4) 1987* (Cth).
[6] Explanatory Memorandum, *New Business Tax System (Thin Capitalisation) Bill 2001*, paragraph 1.7.
[7] As introduced by *Taxation Laws Amendment Act (No 4) 1988* (Cth).
[8] As introduced by *New Business Tax System (Thin Capitalisation) Bill 2001* (Cth).
[9] Legislative references in this paper are to the 1997 Act, including the amendments made by the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Act 2024*, unless the context requires otherwise.
[10] Australian Government Consultation Paper, Government election commitments: Multinational tax integrity and enhanced tax transparency (August 2022) page 6.

Australian business by independent commercial institutions on arm's length terms and conditions. The ALDT has generally been reserved for taxpayers operating in asset-heavy industries where there may be a substantial delay between incurring initial capital expenditure and the later receipt of operational cash flow (for example, real estate, infrastructure, oil and gas, mining) but where it may be demonstrated that the quantum of borrowing is commercially reasonable. More generally, the ALDT was being increasingly used by taxpayers to support higher levels of related party debt, to the frustration of the ATO.

Under the former rules, if an entity was able to establish compliance with either the safe harbour rule or the worldwide gearing test, it was not necessary to demonstrate compliance with the ALDT. In other words, a taxpayer has been able to deduct interest on intra-group debt exceeding arm's length amounts provided that it remained within the safe harbour limits.

3.3 The 'new' (and improved?) Division 820, for most entities

In October 2022, the Government announced that it would be introducing measures, for income years commencing on or after 1 July 2023, to 'strengthen Australia's thin capitalisation rules' and 'to address risks to the corporate tax base arising from the use of excessive debt deductions'.[11] The Government's announcement indicated that:

- the safe harbour tests would be amended to shift towards profits-based testing, rather than an assets-based testing, in most cases; and
- the arm's length test would be retained for an entity's external (ie, third-party) debt.

Both prior to and following the Government's announcement, there has been significant work undertaken by Treasury to draft and implement legislation, including a consultation with industry participants and two senate economic committee inquiries as set out below.

Date	Event
5 August 2022	**Consultation Paper released** The first of the public consultations – being the publication of the Treasury's Consultation Paper, *Government Election Commitments: Multinational Tax Integrity and Enhanced Tax Transparency* (*Consultation Paper*) – commenced in August 2022. Initially, the Federal Government sought to consult on the implementation of various proposals to: • amend Australia's existing thin capitalisation rules;[12] • introduce a rule limiting the ability of multinational groups to claim tax deductions for payments relating to intangibles and royalties; and • ensure enhanced tax transparency by multinationals through measures such as public reporting of tax information. 70 submissions were received by Treasury.

[11] Commonwealth of Australia, Budget October 2022-23: Budget Paper No. 2, page 15.
[12] In the Consultation Paper, the Government had indicated that the treatment of assets and projects that provide 'net public benefits' or are considered 'nationally significant' would be considered in the final design of the fixed ratio test. In the final form of the rules, there is no specific framework – or particular provisions – for assets or project of this nature.

16 March 2023	**First exposure draft released** On 16 March 2023, Treasury published the first exposure draft of the *Treasury Laws Amendment (Measures 4 for Future Bills) Bill 2023* for consultation. This exposure draft also included changes to ensure that taxpayers were no longer able to claim a deduction for interest expenses incurred in deriving non-assessable non-exempt income under section 25-90 of the 1997 Act. This change was not announced in the October 2022 Federal Budget and had the potential to be material for taxpayers who incur interest expenses in relation to their foreign corporate investments. 55 submissions were received by Treasury.
22 June 2023	**Introduction of the Bill to Parliament** Following the consultation on the first exposure draft, a revised set of draft provisions (contained in the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share— Integrity and Transparency) Bill 2023* (the ***Bill***)) were introduced into Parliament in June 2023. As part of this, the Bill removed the proposed changes to section 25-90 but instead introduced a new DDCR to disallow debt deductions incurred on certain debt creation schemes.[13] The insertion of the DDCR was not signalled in the consultation paper or the exposure draft.
22 June 2023	**Referral of the Bill to the Senate Economics Committee for public consultation** The Bill was referred to the Senate Economics Legislation Committee for inquiry and report by 31 August 2023 (later extended to 22 September 2023). 61 submissions were received by, and one public hearing was held by, the Committee.
22 September 2023	**Senate Economics Committee Report released** The Senate Economics Committee issued its report in September 2023, which recommended that the Bill be passed subject to certain technical amendments. At the same time, the Coalition Senators issued a dissenting report, which recommended the removal of the DDCR (and that such rules should be the subject of a separate consultation process).
18 October 2023	**Public consultation on second exposure draft with Parliamentary amendments** An amended exposure draft of the Bill and accompanying explanatory memorandum were circulated for consultation in October 2023. 38 submissions were received by Treasury.
5 December 2023	**Parliamentary amendments were made to the Bill, and referred to the Senate Committee for a second public consultation** A final round of amendments was made, which were intended to 'ensure [that] the new thin capitalisation rules' were appropriately targeted.[14] The Bill, and the proposed parliamentary amendments, were referred to the Committee in December 2023. 30 submissions were received, and one public hearing was held, by the Committee.

[13] Explanatory Memorandum to the Bill, [2.146].

[14] See Supplementary Explanatory Memorandum to the Bill, [1.1].

5 February 2024	**Senate Economics Committee Report released** The Senate Economics Committee published its final report on the Bill, which recommended that the Bill be passed as amended by the December 2023 parliamentary amendments. The Coalition Senators again issued a dissenting report, which recommended various changes to the thin capitalisation rules, and the DDCR.
27 March 2024	**Bill passed by Parliament** The revised Bill was considered by the Senate in March 2024, and then passed by both houses on 27 March 2024 with minor amendments. One of the changes was a requirement for the amendments to be subject to an independent review which must commence no later than 1 February 2026.
8 April 2024	**Bill receives Royal Assent** On 8 April 2024, the Bill received Royal Assent.

Notwithstanding the various stages of consultation that have informed the development of the new rules, considerable complexities remain. The new rules are discussed in the remainder of this paper.

3.4 Commencement date

The new rules will apply:

- retrospectively to assessments for **income years commencing on or after 1 July 2023** for the general thin capitalisation rules (notwithstanding repeated lobbying by industry on their retrospective application); and
- prospectively to assessments for **income years commencing on or after 1 July 2024** for the DDCR, but with no grandfathering for existing arrangements.

4. Australia's new thin cap rules – who does the new regime apply to?

4.1 The new categories of entities

Generally speaking, entities with inbound or outbound foreign investment are captured by the thin capitalisation rules, subject to certain limited exemptions.[15]

Prior to the new rules being introduced, Division 820 differentiated between outward and inward investors, as well as general, financial and ADI entities. This resulted in many categories of entities with different rules applying to each. Under the new rules, which apply retrospectively to income years starting on or after **1 July 2023**, entities will instead be broadly split into three key categories:

(1) **ADIs**: companies that are authorised to carry on a banking business in Australia for the purposes of the *Banking Act 1959* (Cth).

(2) **Financial entities**: entities, other than ADIs, that are licensed securities dealers, licensed derivatives dealers or securitisation vehicles.[16]

(3) **General class investors**: entities, other than financial entities and ADIs, that are subject to the thin capitalisation rules (which broadly means they are an inward or outward investor with the requisite level of foreign ownership or investment). See **section 4.2** below.

The rules are generally not changing for ADIs and Australian plantation forestry entities,[17] which will continue to apply the existing thin capitalisation regime. For the remaining entities, depending on the classification of the entity, one or more of the new tests will be relevant:

		General class investors	Financial entities (non-ADIs)	ADIs and plantation entities
Existing tests	**Safe harbour debt (or capital) test**	X	✓	✓
	Worldwide gearing test	X	✓	✓
	Arm's length debt (or capital) test	X	X	✓
New tests	**Fixed ratio test:** This allows entities to claim net debt deductions up to 30% of tax EBITDA	✓	X	X
	Group ratio test: This allows entities to claim net debt deductions up to the ratio of the worldwide group's net interest expense to EBITDA, with certain adjustments	✓	X	X
	Third-party debt test: Debt deductions not attributable to third-party debt, or which do not satisfy certain additional safeguard rules, are disallowed	✓	✓	X

[15] Examples include entities with de minimis debt deductions in an income year (less than $2 million on an associate-inclusive basis), entities which are special purpose insolvency remote vehicles and certain outward investing entities that hold more than 90% Australian assets on an associate-inclusive basis.
[16] The definition of a 'financial entity' was narrowed as part of the proposed amendments to ensure that certain non-ADI corporations which are registered under the Australian *Financial Sector (Collection of Data Act 2001* (Cth)) and which do not carry on a relevant business of providing finance to non-associate entities (or do not derive all or substantially all of its profits from such a business) are not captured. This means that some entities that were previously classified as financial entities will be now classified as general class investors under the new rules.
[17] An entity that solely or predominantly carries on a business of establishing and tending trees for felling in Australia.

	Debt Deduction Creation Rules: disallows debt deductions for certain debt deduction creation schemes	✓	✓	X

The exemptions from the thin capitalisation rules remain for entities with de minimis debt deductions in an income year (less than AUD $2 million on an associate-inclusive basis), certain outward investing entities that hold more than 90% Australian assets on an associate-inclusive basis (as noted below, however, any such entities would **not** be exempt from the DDCR), and entities which are special purpose insolvency remote vehicles (eg, certain securitisation vehicles).

4.2 Who is a 'general class investor'?

A new definition – a 'general class investor' – was introduced as part of the new measures. This new definition was intended to be a consolidation of the former ‘general’ classes of entities (ie, those entities that were ‘outward investor (general)’, ‘inward investment vehicle (general)’ and ‘inward investor (general)’) and was intended to simplify the operation of Division 820.[18]

Despite the intention, there are some practical anomalies with the way Division 820 now applies, and the entities that it applies to. This is because there are some entities that were subject to the former Division 820 but are not clearly captured by the revised definition of 'general class investor'.

In particular, the definition of a 'general class investor' includes an entity that, *assuming it were a financial entity*, would be an outward investing financial entity (non-ADI).[19] An outward investing financial entity (non-ADI) includes an entity (the ***relevant entity***) that is throughout a period that is all or part of an income year:[20]

- an Australian entity;
- a financial entity; and
- an associate entity of another Australian entity; and
- the other Australian entity is an outward investing financial entity (non-ADI) or an outward investing entity (ADI) for that period.

Based on the final bullet point, the 'relevant entity' would only be a 'general class investor' if the 'other Australian entity' is a financial entity or ADI. Although the rules require that the test entity is assumed to be a 'financial entity', that assumption does not appear to extend to the 'other Australian entity'. In other words, where an entity is an associate entity of an Australian entity that is not itself an outward investing financial entity (or ADI), the first entity may not be a 'general class investor' as defined (and therefore, subject to the new thin capitalisation provisions). This is highly likely to be a mistake because the clear statement in the extrinsic materials was that the new definition of a 'general class investor' was intended to consolidate the previous definitions.[21] Based on a review of submissions provided during the consultation process, however, it appears that this issue was pointed out to Treasury in at least one submission as part of the consultation process (and was not fixed).

There are also other clearer mistakes within the new definitions. For example, there are references to defined terms that have now been repealed (eg, the definition of 'outward investor (financial)' has

[18] Explanatory Memorandum to the Bill, [2.15].
[19] Section 820-46(2).
[20] Section 820-85.
[21] Explanatory Memorandum to the Bill, [2.15].

been repealed but is still used for determining whether an entity is an 'outward investing financial entity (non-ADI)' under the new rules).[22] We expect these issues will need to be remediated through a further round of technical amendments.

4.3 Applicability of tests for each category of entities

4.3.1 General class investors

General class investors will be required to choose, each income year, which of the three new tests they are eligible to and will apply. This choice is generally irrevocable (subject to some limited exceptions) and must be made using an ATO approved form.[23]

If no choice is made by the earlier of the lodgement or the deadline for lodgement of the tax return for that year, the fixed ratio test will be automatically applied (unless the Commissioner agrees to extend the timeframe for lodgement).[24] This automatic deeming rule is different to the former rules where a taxpayer could have applied the best outcome that would arise under any of the three tests.

Notably, where an entity chooses to apply the third party debt test, associate entities in the same 'obligor group' in relation to the relevant debt interest are deemed to have also chosen to apply the third party debt test.[25] This deeming rule (discussed further below) is designed to prevent related entities within a group from electing to apply different thin capitalisation tests to maximise the tax benefits under each test.[26]

4.3.2 Financial entities (non-ADIs)

Financial entities will be required to continue applying the existing asset-based tests rather than the new profits-based tests.[27] This approach is consistent with OECD best practice, recognising that earnings-based tests are unlikely to be appropriate for financial entities. However, these entities will be required to apply the new third-party debt test (rather than the former arm's length debt test).

If a choice is made to apply the third-party debt test, this is generally irrevocable (subject to some limited exceptions) and must be made using an ATO approved form.[28] If no choice is made by the earlier of the lodgement or the deadline for lodgement of the tax return for that year, the existing asset-based tests will apply (unless the Commissioner agrees to extend the timeframe for lodgement).[29]

[22] See section 820-85(2).
[23] See section 820-47.
[24] See section 820-47(2) and 820-50(1)(a).
[25] Section 820-48.
[26] Explanatory Memorandum to the Bill, [2.40].
[27] As noted above, the definition of a 'financial entity' has been narrowed.
[28] See section 820-85(2C).
[29] See sections 820-85(2D) and 820-85(1A)(b)(ii).

4.3.3 ADIs and Australian plantation forestry entities

ADIs and Australian plantation forestry entities will generally continue to be subject to the former Division 820. The rules that apply to these entities are not addressed in this paper.

4.4 Restructuring to comply with the new thin cap rules

A key question taxpayers and their advisors are asking is: can we (re)structure to ensure we comply with the new rules and limit any debt deduction denials? The answer is not so simple.

When a taxpayer is restructuring or unwinding an arrangement in response to a law change, the potential of triggering integrity rules – such as those in Part IVA of the 1936 Act – should be front of mind. The general sentiment seems to be that, provided any restructuring reflects the true commercial and economic circumstances, and the arrangements are not in any way contrived or artificial, such arrangements may not attract the application of these integrity rules.[30] However, in the absence of specific guidance and/or restructuring relief, there is no way to be certain (particularly in light of the new integrity rule – the DDCR).

The ATO has confirmed that it will provide compliance guidance on the Commissioner's application of Part IVA and the specific anti-avoidance provision on certain restructures in response to the new law.[31] In the interim, the ATO has helpfully signalled that it would not be looking to apply integrity rules for legitimate restructurings in response to the thin capitalisation rules changing:

> …we're really mindful that taxpayers will need to manage the transition from the current thin capitalisation regime to the proposed new thin capitalisation regime on passage of the bill, and this may well require restructuring of existing financing arrangements. We're also mindful that there are some concerns within the stakeholder groups about whether that restructuring might fall foul of integrity rules, not just in the measure itself but also more generally. What I'll say about that is that, **as a general principle, the ATO would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law**. This is an approach we have taken in the past.[32]

We eagerly await the release of ATO guidance on restructuring, noting that many taxpayers will be seeking to do so ahead of the commencement of the next financial year on 1 July 2024. We hope that the ATO's approach is similar to that which was taken in relation to the hybrid mismatch rules as set out in Practical Compliance Guideline 2018/7: *Part IVA of the Income Tax Assessment Act 1936 and restructures of hybrid mismatch arrangements*.

[30] See, for example, comments in Taxpayer Alert TA 2016/11: *Restructures in response to the Multinational Anti Avoidance Law (MAAL) involving foreign partnerships*.
[31] See Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation | Australian Taxation Office
[32] Mr Ben Kelly, Deputy Commissioner, Australian Taxation Office, Proof Committee Hansard, 31 January 2024, p 18.

5. Australia's new thin cap rules – how does the new 'fixed ratio test' apply?

5.1 The fixed ratio test

The fixed ratio test replaces the existing safe harbour debt test for general class investors, allowing an entity to claim net debt deductions up to 30% of its 'tax EBITDA'. This is expected to be the primary test for most non-financial entities that are subject to the thin capitalisation rules.

Under the fixed ratio test, disallowed deductions may be carried forward for up to 15 years subject to integrity rules, and subject to the entity continuing to use the fixed ratio test. Further, there is an ability for 'excess tax EBITDA' to be shared with controlling entities (but a 50% or more interest is required).

5.2 What is Tax EBITDA?

The fixed ratio test revolves around the concept of 'Tax EBITDA'. ***Tax EBITDA*** is, broadly, an entity's taxable income or tax loss adding back 'net debt deductions', certain other deductions and prior year losses, as well as removing certain dividend and distribution income. This is provided for in new section 820-52.

(1) An entity's ***tax EBITDA*** for an income year is worked out as follows:

(a) first, work out the entity's taxable income or *tax loss for the income year (disregarding the operation of this Division (other than Subdivision 820-EAA) and treating a tax loss as a negative amount);

(b) next, add the entity's *net debt deductions for the income year;

(c) next, add the sum of the entity's deductions (if any) from its assessable income for the income year that are any of the following:

(i) *general deductions that relate to forestry establishment and preparation costs unless those costs relate to the clearing of native forests;

(ii) deductions under Divisions 40 and 43 (other than deductions for the entire amount of an expense incurred by the entity)

(iii) deductions under section 70-120;

(ca) next, if the entity is an entity to which subsection 820-60(1) applies—add the *excess tax EBITDA amount (if any) worked out under that section for the income year;

(d) next, make adjustments to the result of paragraph (c) or (ca), as the case requires, in accordance with regulations (if any) made for the purposes of this paragraph.

If the result of paragraph (d) is less than zero, treat it as being zero.

Note: The entity's net debt deductions for the income year can be a negative amount.

Tax losses from earlier income years

(1A) In working out the taxable income or *tax loss of a *corporate tax entity for an income year for the purposes of subsection (1), assume that:

(a) the entity chooses to deduct, under subsection 36-17(2) or (3), all of the entity's tax losses for *loss years occurring before the income year; and

(b) subsection 36-17(5) does *not* apply to that choice.

Franked distributions

(2) For the purposes of this section, disregard Division 207, to the extent that Division results in an amount of, or a *share of, a *franking credit being included in the entity's assessable income for the income year.

Dividends etc.

(3) In working out the taxable income or *tax loss of an entity for the purposes of subsection (1), disregard any *dividend or *non-share dividend paid to the entity by an *associate entity and included in the entity's assessable income under section 44 of the *Income Tax Assessment Act 1936*.

The effect of section 820-52(3) is to ensure that dividends which are assessable under section 44 of the 1936 Act are disregarded for Tax EBITDA purposes where the dividend is paid by an associate entity. A modified version of the 'associate entity' definition is used in this context to ensure that related parties with a relevant control interest of 10% or more (rather than the general rule under Division 820 of 50%) are taken to be associate entities. Further, the general requirement that the entity be an associate under section 318 of the 1936 Act is switched off unless the entity is only an associate entity as a result of there being sufficient influence.

The exclusion for dividends under section 820-52(3) was introduced to ensure that, broadly, EBITDA capacity was not able to be duplicated between associate entities.[33] An earlier draft of the legislation excluded all franked distributions and dividends from an entity's tax EBITDA to avoid 'double counting income as [a] dividend represents profits which have already been taxed at the company level and are referable to the company's tax EBITDA'.[34] According to the explanatory materials from that time, this earlier drafting was also intended 'to prevent the duplication of EBITDA capacity between associate entities'.[35] As a result, after the Senate Economics Committee Report in September 2023, the legislation was updated to the form extracted above to more appropriately target this concern. It is not clear to us, however, why subsection 820-52(2) (about franking credits) is not also limited to franking credits attaching to dividend paid by associate entities.

The remainder of section 820-52 provides adjustments to ensure that the definition of Tax EBITDA operates appropriately for trusts (including AMITs), partnerships and R&D entities.[36] In broad terms, the share of the net income of the trust or partnership will be excluded from the Tax EBITDA calculation where the entity is an associate entity. In other words, these adjustments are intended to ensure that such amounts count towards the tax EBITDA of partnerships and trusts, and not the tax EBITDA of the entities which are ultimately assessed on these amounts (eg, partners, beneficiaries and trustees).[37]

Although the test is notionally based on the accounting concept of EBITDA – in line with the Action 4 Report – the concept of Tax EBITDA differs in a number of respects and results in some unusual outcomes:

(1) Entities with non-assessable and non-exempt income

The calculation of Tax EBITDA does not include 'non-assessable non-exempt income' (***NANE***), as this does not form part of the 'taxable income' of an entity. Although this approach is consistent with the Action 4 Report, it does result in the removal of amounts that

[33] See paragraphs 1.73 to 1.81 of the Senate Economics Committee Report into the Bill dated 22 September 2023.
[34] Explanatory Memorandum, [2.61].
[35] Explanatory Memorandum, page 97.
[36] See section 820-52(4) to 820-52(10).
[37] Explanatory Memorandum, [2.69].

could otherwise be income according to accounting concepts (and therefore potentially included in accounting EBITDA).

(2) Segregation of functions across multiple (non-consolidated) entities

For groups which are not consolidated for tax purposes, the fixed ratio test will need to be carefully considered if the operating income is earned by an entity which is distinct from the entity which incurs the relevant debt deductions. Although there is an ability to share 'excess EBITDA', this is limited to circumstances where there is sufficient control between the two entities (see **section 5.4** below).

(3) Not all Division 40 expenditure added back to Tax EBITDA

Deductions referable to the decline in value of certain depreciating assets held by a taxpayer under Division 40 are added back to the definition of Tax EBITDA, except where the amount is immediately allowable as a deduction.

An earlier draft of the legislation had limited the amounts that are added back to those which had been claimed under Subdivision 40-B. As a result of the consultation process, however, this was expanded in the final version to ensure that deductions under other Subdivisions in Division 40 (such as those for project pool amounts and black hole expenses) are also added back to increase the Tax EBITDA.

Unfortunately, amounts which are immediately deductible remain outside of the scope of this provision and are not added back to Tax EBITDA. For example, under Subdivision 40-H, capital expenditure for certain exploration, prospecting, rehabilitation and other activities can be immediately deductible. These deductions are therefore not added back.

(4) CGT discount in a trust reduces the Tax EBITDA

Where a trust has made a capital gain which is eligible to access the CGT discount, the calculation of Tax EBITDA will include that discount capital gain (consistent with the 'net income' of a trust). The effect of this is that the discount reduces the Tax EBITDA for the trust.

Although the consultation process resulted in a number of amendments to the Tax EBIDTA definition, these issues identified above were not resolved through the consultation process.

5.3 The 'special deduction' (ie, the carry-forward rule)

5.3.1 General rule: carry forward accrued disallowed deductions for 15 years

Generally speaking, debt deductions that are disallowed under the fixed ratio test may be carried forward over a 15-year period, referred to as the 'special deduction' rule.[38]

Amounts denied under the fixed ratio test (referred to as ***FRT disallowed amounts***) effectively become loss balances which may be utilised in future years, provided the relevant entity satisfies

[38] See section 820-56.

certain conditions. Similar to other tax losses, the ability for a company or trust to utilise these FRT disallowed amounts is conditioned on the following:

- for a company, satisfying a modified continuity of ownership test or business continuity test; and
- for a trust, satisfying a modified version of the trust loss rules in Schedule 2F of the 1936 Act.[39]

The special deduction rule is particularly relevant for entities with significant upfront expenditure or entities that may not generate taxable income for some years. In a transactional setting, we expect prospective purchasers are likely to take a similar approach to unutilised FRT disallowed amounts as with tax losses – ie, that a company or trust may lose the value of these tax attributes on completion.

5.3.2 No ability to carry forward losses if opt to use another test

If an entity with accrued FRT disallowed amounts later elects to use the group ratio test or third-party debt test, the benefit of those accrued deductions will be lost.[40] However, if the entity ceases to be subject to Division 820 and later becomes subject to Division 820 and does not choose to apply any other test at that time, those FRT disallowed amounts should be available.[41]

5.3.3 Interaction with tax consolidation

The new rules broadly align the treatment for accrued FRT disallowed amounts with the existing interaction between tax losses and the tax consolidation regime. This means that where an entity with accrued FRT disallowed amounts joins a tax consolidated group:

- the FRT disallowed amounts may be transferred to the head company of the group, subject to a utilisation test in the 'trial year' (generally the 12-month period finishing immediately after the joining time).[42] If this utilisation test is failed on joining, the FRT disallowed amount is lost;[43]
- the head company is generally treated as having the FRT disallowed amounts for the income year in which it was accrued by the joining entity (to preserve the 15-year limit for FRT disallowed amounts), other than for the purpose of applying the modified continuity of ownership tests that are used under the special deduction rule discussed above;[44]
- the head company can make an irrevocable choice to cancel the transfer of the FRT disallowed amounts. If this occurs, the FRT disallowed amounts can no longer be used;[45] and
- the consolidation entry and exit ACA provisions are adjusted to ensure they operate appropriately to FRT disallowed amounts (in substantially the same way as other tax losses

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[39] Section 820-59. The rules rely on the existing integrity rules for the use of prior year tax losses for companies and trusts, with minor amendments for companies (see section 820-59(4)). These rules are complex and are not addressed in any detail in this paper.
[40] Section 820-58.
[41] See Explanatory Memorandum, [2.118].
[42] Section 820-590.
[43] Section 820-593.
[44] Section 820-591.
[45] Section 820-592.

which may be transferred into a consolidated group).[46] If the head company chooses to cancel the transfer of the FRT disallowed amounts, no related adjustments should be made to the ACA on entry into the group.

5.4 Socialisation of 'Excess EBITDA'

During the consultation process, industry lobbied for changes to the way that trust structures were required to apply the fixed ratio test under the new rules. The Senate Economics Committee recognised that technical amendments were required to accommodate such structures. As a result, the Excess EBITDA provisions were introduced to allow sharing of excess 'Tax EBITDA' with Australian resident unit trusts (including through a relevant chain of such trusts). These changes are critical for infrastructure projects in particular, given debt is often sourced by a special purpose finance company, rather than the entity that operates the relevant business or investing activities. As the consultation process progressed, the Excess EBITDA provisions were also extended to companies and partnerships.

The fixed ratio test therefore includes an ability to allow eligible entities to transfer their excess Tax EBITDA to certain other eligible entities.[47] The amount that can be transferred is calculated with reference to the transferee entity's average direct control interest in the transferor entity for the relevant income year, and only days where the direct control interest is 50% or more count towards the average control interest for that year. For example, where an eligible entity has a direct control interest of 80% for each day in the income year, they may be entitled to, broadly, 80% of the excess Tax EBITDA.[48]

Mechanically, this is achieved by an entity's Tax EBITDA being computed to include any Excess EBITDA amount.[49] Only general class investors that are applying the fixed ratio test, and which are one of the following types of entities, are 'eligible' for these purposes:

- A company that is an Australian entity (as defined under section 995-1(1)).
- A unit trust that is a resident trust for CGT purposes (as defined under section 995-1(1)).
- A managed investment trust (or MIT).
- A partnership that is an Australian entity, with that term being modified by to ensure that partnerships with a strong connection to Australia are captured (ie, where 50% or more of the direct participation interests in the partnership are held by Australian residents and/or Australian residents).

As discussed above, there appears to be an unresolved question about how the second limb of the 'general class investor' test would apply to an entity where the 'other Australian entity' is not, itself, an outward investing financial entity (or ADI). The resolution of that issue would also affect how Excess EBITDA amounts may be shared amongst associate entities.

It remains to be seen how these rules will apply to custodian relationships. In particular, whether the custodian relationship would mean that excess Tax EBITDA is not able to be shared between trusts where a custodian relationship exists (as the custodian trust may not be a unit trust). Although this is

[46] Sections 820-594, 705-60, 705-65 and 705-112.
[47] Section 820-60.
[48] See section 820-60(3).
[49] Section 820-52(1)(ca).

generally addressed for AMITs through the existing legislation,[50] it is not clear how this will operate for other trusts and MITs.

5.5 Practical comments

Investors will need to be mindful of the effect that the new fixed ratio test will have on the after-tax returns for an investment compared to the position under the former safe harbour rules. This is particularly so in circumstances where it is possible that the relevant entity will be sold during or shortly after a low-profit lifecycle, due to the loss of certain carry-forward 'disallowed deductions' under the fixed ratio test unless, for a company, the business continuity test is satisfied (discussed above).

In addition, we raise some practical comments regarding the application of the fixed ratio test:

(1) 'Net debt deductions'

As the test focuses on an entity's 'net debt deductions', the amount added back to taxable income, and the denial of debt deductions, is limited to the *excess* of debt deductions over certain amounts included in the entity's assessable income (for example, amounts which are interest or of an interest nature).[51] In other words, where an entity has nil or negative net debt deductions, no amounts will be denied under the fixed ratio test.

By way of example, if an entity has $1,000 of interest income and a $800 interest expense, only $200 of net interest income should be taken into account in determining the relevant Tax EBITDA (and also when determining the amount of debt deductions that may be denied). In this example, no debt deductions should be disallowed under the fixed ratio test. The rationale for this is to ensure interest income is able to flow up a chain of entities even where part of the interest expense is denied at a lower level.

(2) Misalignment between Tax EBITDA and Excess EBITDA

There is a misalignment between the definition of 'Tax EBITDA' and the Excess EBITDA provisions which will be particularly relevant for consortium investors in infrastructure projects.

Broadly, under the definition of 'Tax EBITDA', distributions from a trust in which an entity holds a 10% or greater interest are included in the calculation of 'Tax EBITDA', whereas, unless that entity holds an interest in the trust of 50% or more, they are not able to benefit from any Excess EBITDA in relation to the trust. The policy reason for this difference is not entirely clear but for the fact that it is a concessional measure and a departure from the OECD position.

The ATO has acknowledged the need for guidance to be provided in relation to the application of the fixed ratio test, including the calculation of 'Tax EBITDA', 'Excess EBITDA' and FRT disallowed amounts. As at the date of this paper, no guidance has been released.

[50] See section 276-115.
[51] See section 820-50(3).

6. Australia's new thin cap rules – how does the new 'group ratio test' apply?

6.1 The new group ratio test

The amendments will introduce a group ratio test, replacing the existing worldwide gearing test for 'general class investors', allowing an entity to deduct 'net debt deductions' in excess of (or below) the amount permitted under the fixed ratio rule. As such, this test will be relevant for highly leveraged groups.

Where the group ratio test applies, debt deductions are limited based on a financial ratio of the group – referred to as the ***group ratio earnings limit*** – which is calculated by reference to the relevant financial statements of the group. As with the fixed ratio test, as the test focuses on an entity's 'net debt deductions', the amount added back to taxable income, and the denial of the debt deductions, is limited to the *excess* of debt deductions over certain amounts included in the entity's assessable income (for example, amounts which are interest or of an interest nature).[52]

Unlike the fixed ratio test, however, there is no ability for disallowed deductions to be carried forward or shared with controlling entities.

6.2 What is the group ratio earnings limit?

The group ratio test revolves around the concept of the 'group ratio earnings limit'.

Where a general class investor is a member of a ***GR Group,*** it can make an election to apply the group ratio test. A ***GR Group*** is a group which includes either a ***worldwide parent entity*** or a ***global parent entity*** and each entity that is fully consolidated with that parent entity in the relevant financial statements.

Broadly, if the group ratio test is chosen by an entity, that entity's 'group ratio earnings limit' for an income year is equal to that entity's tax EBITDA for the income year multiplied by its 'group ratio' for the income year.[53] The relevant 'group ratio' is calculated by reference to the GR group EBITDA and the GR group net third party interest expense, as determined in accordance with the relevant financial statements (with certain adjustments to ensure amounts which are equivalent to interest are captured, and amounts which are paid to associates are disregarded).[54] As the calculations rely on financial statements which may not be publicly available, there is an express contemporaneous record keeping rule included in section 820-985.

The ATO has acknowledged the need for guidance to be provided in relation to the application of the group ratio test and, in particular, the calculation of the 'group ratio' and the identification of relevant financial statements. As at the date of this paper, no guidance has been released.

[52] See section 820-50.
[53] See section 820-51(2).
[54] See sections 820-53 to 820-55.

7. Australia's new thin cap rules – how does the new 'third party debt test' apply?

7.1 The new third party debt test

Under the 'former' Division 820, the ALDT allowed debt deductions – including for related-party transactions – to be claimed based on a quantum of debt that would, broadly, be deemed reasonable if it were an arm's length transaction (ie, if the borrowing did not exceed the amount of debt the taxpayer would reasonably be expected to have borrowed, and the amount of debt that would reasonably be expected to have been provided to the Australian business by independent commercial lending institutions on arm's length terms and conditions).

The Australian government's announcement as part of the 2022-23 October Federal Budget included a commitment to retain an arm's length test for an entity's third-party debt but not related-party transactions. While this commitment has broadly been kept, the new rules have replaced the former arm's length test with a new, and far narrower, third-party debt test (***TPDT***). The TPDT replaces the arm's length debt test for general class investors and financial entities (but ADIs will continue to be able to access the existing arm's length capital test and will not be required to apply the TPDT).

Under the new TPDT test, debt deductions (rather than net debt deductions) of an entity, which are not attributable to third party debt, are disallowed. In other words, only debt deductions *attributable*[55] to debt interests that satisfy the ***third party debt conditions*** in an income year will be allowed.[56]

The ***third party debt conditions*** can be summarised as follows:

	Third party debt conditions
No related-party debt	The relevant debt interests must not be issued to, or held by, 'associate entities' of the borrower at any time in the income year.
Recourse to only Australian assets	The lender to the borrower must only have recourse to <u>Australian assets</u> that are: (i) held by the borrower; (ii) membership interests in the borrower (unless the borrower has an interest in an asset which is not an Australian asset); or (iii) held by an Australian entity that is a member of the same obligor group as the borrower in relation to that debt interest. The phrase 'Australian assets' is **not** defined, but the Explanatory Memorandum notes that it is intended to capture assets that are 'substantially connected to Australia' but not assets attributable to an overseas permanent establishment, or offshore commercial activities of an entity.[57] Although there is a carve-out for circumstances where the lender has recourse to minor or insignificant assets, there is also an express prohibition on credit support except in limited circumstances. These requirements are discussed further below in **sections 7.2** and **7.3**.

[55] Debt deductions that are directly associated with hedging or managing interest rate risk of a debt interest (and are not referable to amounts paid, either directly or indirectly, to an associate entity) are deemed to be *attributable* to a debt interest under section 820-427A(2).
[56] See section 820-427A(3).
[57] Explanatory Memorandum to the Bill, [2.98].

Must be used to generate Australian assessable income	The borrower must use all, or substantially all, of the proceeds from issuing the debt interest to fund the borrower's Australian commercial activities. It is not permitted to use the proceeds for carrying on a business through an overseas permanent establishment, or for the holding of any associated entity debt, controlled foreign entity debt or controlled foreign entity equity. This will require entities to undertake, and maintain adequate records, a robust tracing exercise to establish the use of the proceeds from each debt interest as many loan documents will not include limitations on the use of funds in this manner – for example, there is generally no express limitation on the use of funds in connection with commercial activities in Australia.
Must be an 'Australian entity'	The entity must be an Australian entity (noting that this definition is modified by section 820-427E).

Each debt interest that is on issue with relevant debt deductions in an income year is required to be tested with reference to these conditions and, unlike the fixed ratio test, there is no ability for disallowed deductions to be carried forward or shared with controlling entities.

Although Parliament's intention was for the new TPDT to be 'a simpler and more streamlined test to apply and administer than the former arm's length debt test'[58] (as the former test required a hypothesised entity comparison and certain valuation metrics to be used), there remain considerable complexities associated with applying the new TPDT.

7.2 Recourse to (only) Australian assets

As noted above, one of the requirements for a debt interest to satisfy the third party debt conditions is that the lender has recourse only to *Australian assets* that are:

(a) held by the borrower;

(b) membership interests in the borrower (unless the borrower has a legal or equitable interest, whether directly or indirectly, in an asset that is not an Australian asset); or

(c) held by an Australian entity that is a member of the same obligor group as the borrower in relation to that debt interest,

Unhelpfully, as noted above, there is no definition of Australian assets. In practice, taxpayers may have difficulty in determining whether an asset is an *Australian* asset. For example, if Company A (the borrower) holds membership interests in Company B (an Australian incorporated entity that holds some foreign assets), are those membership interests in Company B an Australian asset of Company A?

There is a carve-out for circumstances where the lender has recourse to minor or insignificant assets to ensure that the third party debt test is not failed as a result of immaterial foreign assets being held. The ATO is yet to publish public guidance on how it intends to administer the 'minor or insignificant assets' exclusion and the extrinsic materials provide little guidance as to its interpretation. The Supplementary Explanatory Memorandum to the Bill provides (at [1.30]):

> Recourse to minor and insignificant ineligible assets (i.e., assets which are not mentioned in the paragraph immediately above, such as an asset which is not an Australian assets) is disregarded. This

[58] See Explanatory Memorandum, [2.91].

> allowance is intended to prevent paragraph 820-427A(3)(c) being contravened for inadvertent and superficial reasons. Determining whether recourse to ineligible assets is minor and insignificant will generally require a consideration of the ineligible assets to which recourse for payment of the debt can be had and whether those ineligible assets are of a minor and insignificant nature.

Accordingly, one must have regard to the ordinary meaning of the terms 'minor' and 'insignificant' to interpret the exclusion. The term 'minor' has a relevant ordinary meaning "of or relating to the minority" and "one of inferior rank or importance in a specified class" (*Macquarie Dictionary*) and the term 'insignificant' has a relevant ordinary meaning of "unimportant, trifling, or petty, as things, matters, details, etc." and "too small to be important". Since the exclusion was enacted, it has been suggested by industry members that the exclusion might apply to:[59]

- assets that are material in value but fleeting by reference to time (eg, cash in a foreign bank account that is then withdrawn after a short period into an Australian bank account); and
- assets that are long standing, but de minimis by value.

In the absence of guidance, and depending on the circumstances of the entity and the borrowing, it may be reasonable that the exclusion should apply to such assets. In addition, assets of which the relevant entity has no knowledge or reasonable grounds to suspect exist (and which, on becoming aware, arranges for their transfer to Australia or disposal) may be captured by this carve-out.

7.3 The role of credit support

There is an express prohibition on the lender having recourse to any rights under or in relation to a guarantee, security or other form of credit support.[60] The rationale for this exclusion is to ensure that multinational groups are not able to highly leverage their Australian operations (relative to their operations elsewhere) by providing credit support and 'debt dumping' in Australia.[61] There are two key exceptions to this rule:

- Credit support which is expressly allowed under the legislation, broadly meaning the credit support must be:[62]

  (a) (**recourse to Australian assets)** a right that provides recourse, directly or indirectly, only to one or more Australian assets that are: (i) held by the borrower; (ii) membership interests in the borrower; or (iii) held by an Australian entity that is a member of the same obligor group as the borrower in relation to that debt interest;

  (b) **(third party credit support)** a right that is provided by an entity which is not an associate entity of the borrower; or

  (c) **(right relating to qualifying Australian land)** a right relating to, broadly, the creation or development of certain Australian real property assets (including moveable property situated on such land where it is expected to be relevant to the income producing use of the land and is situated on the land for most of its useful life – eg, renewable energy producing moveable property), offshore renewable energy

[59] CPA Australia, *Amendments to the Thin Capitalisation rules – ATO's Public Advice and Guidance (PAG) consultation,* 13 February 2024.
[60] Section 820-427A(3)(c).
[61] See Explanatory Memorandum, [2.99]-[2.101].
[62] See section 820-427A(5)(a).

infrastructure or offshore electricity transmission infrastructure (which will be relevant for greenfield investments).

Notwithstanding the above, importantly, a right will **not** be allowed where it is ultimately provided by a foreign entity that is an associate entity of the borrower.[63]

- The limited look-through rule for conduit finance vehicles applies (discussed in **section 7.4**).

The credit support requirement is not expected to be a significant issue for entities that provide credit support within the same tax consolidated group with Australian assets, but will be more complicated for entities that are grouped in different ways, and will be problematic for entities that rely on security provided by foreign entities.

In addition, generally lenders would seek to have recourse over all assets and entities held by a borrower and any relevant guarantor, whether or not those assets are located in Australia. As a result, where the borrower holds assets not located in Australia, the TPDT may not be available unless a lender agrees to forgo receiving security over membership interests in the borrower and any non-Australian assets held by the borrower. For existing debt arrangements, this could necessitate engagement with external lenders.

7.4 Deemed application of the TPDT

7.4.1 Obligor group entities that are 'associate entities'

Where a lender has recourse for payment to some or all of the assets of one or more other entities, each of these entities is taken to be an ***obligor entity*** and part of the same ***obligor group*** as the borrower in relation to the relevant debt interest.[64] This does not extend to assets which are solely membership interests in the borrower (ie, the entities that hold only these assets will not form part of the obligor group even where the lender has recourse to these assets).[65]

Where an entity has made an election to apply the TPDT, that entity and all other members of that entity's 'obligor group' which are also 'associate entities' and are required to lodge an income tax return in the year are deemed to have applied the same test.[66] A modified version of the 'associate entity' definition is used in this context to ensure that related entities with a relevant control interest of 20% or more (rather than the general rule under Division 820 of 50%) are generally taken to be associate entities.[67]

7.4.2 Stapled structures: entities that are party to a relevant 'cross-staple arrangement'

Where an entity has made an election to apply the TPDT, relevant entities within a stapled structure group that have entered into a relevant 'cross-staple arrangement' are deemed to have:

[63] See section 820-427A(5)(b).
[64] Section 820-49.
[65] Section 820-49(3).
[66] Section 820-48(1).
[67] Section 820-48(2).

- applied the same test (ie, the TPDT);[68] and
- to be associate entities for the purpose of applying the TPDT, including the conduit finance relief discussed below.[69]

Although it was clear that this deeming rule was intended to apply to stapled structures, the drafting may allow unintended arrangements to be captured (due to the broad definition of 'cross staple arrangement' in section 12-436 of Schedule 1 to the *Taxation Administration Act 1953* (Cth)).

7.5 The rule for conduit financers

When drafting the new legislation, Treasury recognised that taxpayers use conduit financing arrangements to 'streamline and simplify borrowing processes' for a group.[70] For this reason, a limited look-through rule has been included to allow conduit finance vehicles that provide direct funding to other group entities to do so on back-to-back terms without breaching the TPDT.

The ***conduit financing conditions,*** if satisfied, permit certain related party debt issued to a conduit borrower also to satisfy the ***third party debt conditions***. The effect of the conduit financing rules is that the on-lending must satisfy ***both*** the conduit financing conditions in section 820-427C and the third party debt conditions in section 820-427A, with some modifications.

A debt interest will generally satisfy the ***conduit financing conditions*** where it meets the following requirements:[71]

	Conduit financing conditions
The ultimate debt must be third-party debt	The ultimate lender that holds the ***ultimate debt interest*** must not be an 'associate entity' of the conduit financer. This means that the ultimate borrowing must be, in essence, external third-party debt.
The conduit financer must on-lend to one or more associate entities	The conduit financer must on-lend to one or more associate entities. These associate entities are then able to on-lend to another entity that is an associate entity of both the conduit financer and that entity (ie, if there is a chain of associate entities). Each such borrower is referred to in this paper as a ***conduit borrower***.
The on-lending must be funded with proceeds from the ultimate debt interest	The on-lending to conduit borrowers must be financed by the conduit financer only using proceeds from the ultimate debt interest (and this requirement must be satisfied for any subsequent on-lending to other conduit borrowers).
Costs must be on-lent on the same terms	The terms of the relevant debt interest, to the extent that those *terms relate to costs incurred* by the relevant conduit borrower, must be the *same* as the terms of the ultimate debt interest. The new rules provide that, for the purpose of determining whether the terms are the same, an entity must disregard:[72] • terms of the debt interest related to quantum; • terms of the debt interest that relate, directly or indirectly, to the recovery of reasonable, direct administrative costs;

[68] Section 820-48(3).
[69] Section 820-427D(2).
[70] Explanatory Memorandum to the Bill, [1.78].
[71] See section 820-427C.
[72] Section 820-427C(2).

	• terms of the debt interest that have the effect of allowing the recovery of certain interest rate swap costs that are deemed to be a debt deduction. Taxpayers will need to be able to demonstrate that, for each relevant borrowing, it is on the same terms to the extent those terms relate to costs incurred (eg, interest costs), which will require a strict tracing exercise. We expect that these terms would include, among others, terms regarding interest rates, repayments and gross-up provisions.
Must be an 'Australian entity'	The conduit financer, borrower and each conduit borrower (if any) must be an Australian entity.
The conduit financer and each conduit borrower must apply the ALDT:	The conduit financer, borrower and each conduit borrower (if any) must not apply the fixed ratio test or group ratio test. There is, however, no express requirement that these entities have made an election to apply the TPDT. This means that a failure to make an election, for example because the debt deductions in that entity are de minimis and not claimed as a deduction, does not preclude the other entities from satisfying the conduit financer conditions.

Importantly, for a debt interest that has satisfied the conduit financing conditions, there is a modification to the requirement that the lender must only have recourse to specific assets (as noted above in **section 7.2**). Where the conduit financing conditions are satisfied in relation to a debt interest, the external lender is able to have access to the Australian assets of the Australian resident conduit financer and each conduit borrower (as well as any Australian resident obligor entity).[73]

7.6 Practical comments

The TPDT is relatively narrow in its application and may not apply to common commercial arrangements unless a restructure or reorganisation is undertaken. In addition, we raise some practical comments regarding the application of the TPDT:

(1) Tracing of existing debt interests

Money is fungible, so we expect there will likely be practical challenges with tracing from a pool of funds.

The operation of the requirement that the conduit financer 'financed the amount' loaned to the conduit borrowers from the ultimate debt interest may be less practically challenging in circumstances where, after 1 July 2023, a new conduit financer arrangement is established. The conduit financer could, for example, use the funds raised from issuing the ultimate debt interest to finance the amounts loaned to the conduit borrowers, and would maintain satisfactory documentation to demonstrate that flow of funds.

Where, however, an existing conduit financer arrangement is in place as at 1 July 2023, the existing arrangement may need to be restructured to some extent to comply with the new conduit financer conditions. It may not be practical, or even feasible, for the conduit financer to redeem and reissue the pre-existing 'ultimate debt interest', because this pre-existing debt interest would be held by third party lenders. As such, absent administrative guidance from the ATO, it is not clear how the conduit financer can lend amounts to the conduit borrowers and demonstrate that the lending has been financed only with the funds raised from the ultimate debt interest.

[73] Section 820-427B(2)(b).

We raised during the consultation process that there needs to be an express acknowledgment that such amounts will be taken to be 'financed' by the original external debt interest which may have been previously on-lent. Unfortunately, this was not addressed in the revised drafting prepared by Treasury.

(2) Hedging costs in conduit financer arrangements

Debt deductions that are directly associated with hedging or managing interest rate risk of a debt interest (and are not referable to amounts paid, either directly or indirectly, to an associate entity) are deemed to be *attributable* to a debt interest under section 820-427A(2).

However, it is not clear that debt deductions associated with hedging or managing the interest rate risk in respect of an on-lending arrangement with a conduit borrower will be *attributable* to the on-lending arrangement because of the exclusion in section 820-427A(2) for such debt deductions referable to an amount paid or payable to an associate entity. If this is the case, however, the conduit borrower may still be able to compensate the conduit financer for its own hedging costs in relation to the ultimate debt interest.[74]

It is also unclear whether it is permissible under the conduit financing rules to enter into a back-to-back swap which mirrors the external swap entered into by the conduit financer. This is because the conduit financer only appears permitted to recover hedging costs from the conduit borrower on a direct basis, and potentially not benefits from an in-the-money swap arrangement. There may be alternative views in this regard, however, which would support the view that a conduit financer is permitted to pass on both the costs *and* benefits of hedging (eg, the requirement that the terms of the on-loan are the same as the ultimate debt interest extends only to 'costs' and not to 'benefits').

(3) Use of funds – refinancings and distributions

One of the conditions to satisfy the third party debt conditions is that the issuer of the debt interest uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia that do **not** include:

(a) any business carried on by the entity at or through its overseas permanent establishments; and

(b) the holding by the entity of any associate entity debt, controlled foreign entity debt or controlled foreign entity equity.[75]

Where the proceeds are used for the purposes of refinancing existing debt, the explanatory materials do not provide guidance on how the 'use of proceeds' requirement should be analysed. There is an open question whether refinancing external debt (including existing debt held by a foreign third party lender) would satisfy the condition that the proceeds relate only to funding the commercial activities of the borrower in connection with Australia. One argument may be that if the original debt was used for a purpose consistent with section 820-427A(3)(d), the refinancing of that existing debt should also be for a use that is consistent with that section.[76] Alternatively, it could be argued that the refinancing of existing debt relieves

[74] See sections 820-427C(1)(d) and 820-427C(2)(d)(ii).

[75] See section 820-427A(3)(d).

[76] Such an approach would be consistent with the approach taken to determine whether interest on refinanced debt or compounding interest is deductible for tax purposes, which involves an examination of the underlying use or purpose of the loan proceeds (*FCT v Jones* (2001) ATC 4607 and (2002) ATC 4135, TR 2004/4; see also TD 2008/27 and *FCT v Hart* (2004) 217 CLR 216).

the borrower of a liability which, by virtue of its business consisting of commercial activities in Australia, constitutes the use of proceeds for that purpose. However, in the absence of ATO guidance, this remains an open question.

Where the proceeds are used for the purposes of funding a distribution to an associate entity, the explanatory materials similarly do not provide guidance. Although the DDCR is switched off where a party has elected to apply the TPDT, it is not clear whether a third-party borrowing for the purpose of making a distribution to an associate entity would be for the purpose of funding commercial activities in connection with Australia – particularly where the recipient of the distribution is a foreign entity. Again, in the absence of guidance, this remains an open question.

(4) Use of funds – conduit financing arrangements

As noted above, one of the conditions to satisfy the third party debt conditions is that the issuer of the debt interest uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia (other than certain excluded uses).[77] Although the issuer is permitted to use the funds to on-lend to associate entities in a manner that complies with the conduit financer conditions, it does raise a question whether this on-lending is to fund the conduit financer's commercial activities (or whether you can, or should, take into account the activities conducted by the conduit borrowers).

The ATO has acknowledged the need for guidance to be provided in relation to the application of the third party debt test. In particular, the ATO proposes to provide interpretive guidance on key aspects of the third-party debt conditions (for example, ‘minor or insignificant’ in 820-427A(3)(c)) as a matter of priority. As at the date of this paper, no guidance has been released.

[77] See section 820-427A(3)(d).

8. Australia's new thin cap rules – other key changes

8.1 There is a new, expanded definition of 'debt deductions'

The amendments also extended the definition of 'debt deductions' in section 820-40 of the 1997 Act to capture both interest and amounts economically equivalent to interest. To broaden the definition further, the definition of 'debt deductions' has also been amended to ensure that a cost incurred by an entity does not need to be incurred in relation to the relevant 'debt interest' issued by that entity in order to be captured. As a result, section 820-40(1) has been modified in the following way:

> Debt deduction, of an entity and for an income year is a cost incurred by the entity ~~in relation to a debt interest issued by the entity~~ to the extent that:
>
> (a) the cost is:
>
> (i) interest, an amount in the nature of interest, ~~or any other amount that is calculated by reference to the time value of money~~ or any other amount that is economically equivalent to interest; or
>
> (ii) the difference between the financial benefits received, or to be received, by the entity under ~~the~~ a scheme giving rise to ~~the~~ a debt interest and the financial benefits provided, or to be provided under that scheme; or
>
> (iii) any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under ~~the~~ a scheme giving rise to ~~the~~ a debt interest; and
>
> (iv) any other expense incurred by the entity that is specified in the regulations made for the purposes of this subparagraph.

Although the common law meaning of 'interest' is well understood,[78] there is little guidance on what constitutes an amount which is 'economically equivalent to interest'. This issue has been canvassed by industry bodies but remains unresolved.[79] In the meantime, as these amendments are consistent with the OECD best practice guidelines, guidance can be found in Chapter 2 of the Action 4 Report. Further, in an Australian context, guidance may be drawn from the application of the interest withholding tax rules (which capture, amongst other things, amounts that are in the nature of interest or amounts to the extent that they can reasonably be regarded as having been converted into a form that is in substitution for interest). Given the different language used in the new thin capitalisation rules and the existing interest withholding tax rules, however, it does leave open the possibility that an amount will be captured as 'interest' for the purpose of one set of rules and not the other.

[78] In other contexts, Courts have generally considered an amount to be 'interest' if the amount: (i) is calculated by reference to the outstanding principal amount; (ii) is due to the lender or the person entitled to receive the interest; and (iii) is calculated by reference to time. See *Federal Commissioner of Taxation v Century Yuasa Batteries Pty Ltd* (1998) 82 FCR 28.

[79] These issues have been raised by various industry members, including CPA Australia, in their submission to the ATO titled *Amendments to the Thin Capitalisation rules – ATO's Public Advice and Guidance (PAG) consultation,* 13 February 2024.

Further, section 820-40(3) has been amended as follows:

> To avoid doubt, the following amounts that are incurred by an entity in relation to a debt interest issued by the entity are not covered by paragraph (1)(a) [extracted above]:
>
> (a) ~~losses and outgoings directly associated with hedging or managing the financial risk in respect of the debt interest~~;
>
> (b) losses incurred by the entity in relation to which the following apply:
>
> (i) the losses would otherwise be a cost covered by sub-paragraph (1)(a)(ii); but
>
> (ii) the benefits measured in that subparagraph are measured in a foreign currency … and the losses have arisen only because of changes in the rate of converting that foreign currency …. Into Australian currency;

Although the change to section 820-40(3) is intended to ensure that interest related costs (eg, interest rate swaps) are captured by the definition of a 'debt deduction', it is not clear which paragraph in section 820-40(1)(a) these would be captured by. Depending on the terms of the relevant swap, we expect these costs would be most likely captured by (a)(iii) (or, less likely, (a)(ii)) as such amounts are unlikely to be economically equivalent to interest.

8.2 The definition of 'associate entity' now excludes complying superannuation funds

The amendments narrow the definition of 'associate entity' in section 820-905 to expressly exclude a trustee of a complying superannuation entity (other than a self-managed superannuation fund) and any wholly-owned subsidiaries of that complying superannuation entity. The rationale for this is that these entities are subject to a robust regulatory regime and do not generally exercise control over entities that would otherwise be 'associate entities' and so should not be captured by the 'associate entity' definition in the thin capitalisation rules.[80]

8.3 Multiple definitions of 'associate entity'

The new rules have modified the definition of 'associate entities' to capture entities where there is a certain control interest of either 10% or 20%. In each case, this has the potential to capture a significant number of related entities (eg, minority investors and joint venture entities may now be captured).

However, the definition of 'associate entities' applies in different contexts in different ways. We set out below a table to show how the definition of 'associate entity' has been amended under the new rules, depending on the context:[81]

	Broad overview
General position under Division 820 **(section 820-905)**	An entity (the first entity) that is not an individual is an associate entity of another entity at a particular time if, at that time, the first entity is an *associate of that other entity and at least one of the following paragraphs applies:

[80] Explanatory Memorandum, [2.162].
[81] There are specific rules that apply to registered entities and, in some contexts, trusts and partnerships. These are not addressed in this table.

	(a) that other entity holds an *associate interest of **50%** or more in the first entity; (b) the first entity is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of that other entity in relation to: (i) the distribution or retention of the first entity's profits; or (ii) the financial policies relating to the first entity's assets, *debt capital or *equity capital; whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed entities.
Fixed Ratio Test	
Tax EBITDA calculation **(section 820-905 as modified by section 820-52(9))**	For the purpose of applying sections 820-52(3), (6), (6B) and (8), the application of section 820-905 is modified in the following key ways: 1. The relationship is tested using a 'TC control interest of **10%** or more' with some modifications (rather than an 'associate interest of 50% or more'). 2. The requirement that the entity is an 'associate' under section 318 of the 1936 Act is disregarded, unless the entity is only an associate entity as a result of there being sufficient influence under section 820-905(1)(b).
Group Ratio Test	
Tax EBITDA calculation **(section 820-905 as modified by section 820-52(9))**	For the purpose of applying sections 820-52(3), (6), (6B) and (8), the application of section 820-905 is modified in the following key ways: 1. The relationship is tested using a 'TC control interest of **10%** or more' with some modifications (rather than an 'associate interest of 50% or more'). 2. The requirement that the entity is an 'associate' under section 318 of the 1936 Act is disregarded, unless the entity is only an associate entity as a result of there being sufficient influence under section 820-905(1)(b).
Calculation of financial statement net third party interest expense and adjusted net third party interest expense **(section 820-905 as modified by section 820-54(5))**	For the purpose of applying sections 820-54(3) and (4), the application of section 820-905 is modified in the following key ways: 1. The relationship is tested using a 'TC control interest of **20%** or more' with some modifications (rather than an 'associate interest of 50% or more'). 2. The requirement that the entity is an 'associate' under section 318 of the 1936 Act is disregarded, unless the entity is only an associate entity as a result of there being sufficient influence under section 820-905(1)(b).
Third party debt test	
Application of third party debt test **(section 820-905 as modified by section 820-427D)**	For the purpose of applying Subdivision 820-EAB (*Third party debt concepts*), other than section 820-427A(5)(b), the application of section 820-905 is modified in the following key ways: 1. The relationship is tested using a 'TC control interest of **20%** or more' with some modifications (rather than an 'associate interest of 50% or more'). 2. The requirement that the entity is an 'associate' under section 318 of the 1936 Act is disregarded, unless the entity is only an associate entity as a result of there being sufficient influence under section 820-905(1)(b).

	3. An entity is deemed to be an associate entity of another where the two entities have entered into a 'cross staple arrangement' and the other entity is itself an associate entity of a conduit financer. The result of this is that relevant entities in a stapled group will generally be deemed associate entities for the purpose of applying the third party debt test (and, in particular, the conduit financer relief).
Application of credit support rules **(section 820-905 as modified by section 820-427D)**	For the purpose of section 820-427A(5)(b), the application of section 820-905 is modified in the following key ways: 1. The relationship is tested using a 'TC control interest of **50%** or more' with some modifications (rather than an 'associate interest of 50% or more'). 2. The requirement that the entity is an 'associate' under section 318 of the 1936 Act is disregarded, unless the entity is only an associate entity as a result of there being sufficient influence under section 820-905(1)(b). 3. An entity is deemed to be an associate entity of another where the two entities have entered into a 'cross staple arrangement' and the other entity is itself an associate entity of a conduit financer. The result of this is that relevant entities in a stapled group will generally be deemed associate entities for the purpose of applying the third party debt test (and, in particular, the conduit financer relief).

9. Australia's new thin cap rules – transfer pricing interaction

9.1 Debt quantum

The BEPS Action 4 Report acknowledged that some countries may choose to apply arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.[82]

Australia's transfer pricing provisions, as contained in Subdivision 815-B, require the consideration of the conditions that operate between an Australian entity and an entity in another jurisdiction in connection with their commercial or financial relations (the 'actual conditions'). If the actual conditions differ from those conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances (referred to as the 'arm's length conditions'), a 'transfer pricing benefit' may arise. In this case, the arm's length conditions can be substituted in place of the actual conditions.

Australia's transfer pricing rules do not define the meaning of the word 'condition' (consistent with the OECD's Commentary on the Associated Enterprises article of the OECD Model or its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations). Notwithstanding this, OECD commentary indicates that the word 'condition' could include the quantum of debt in respect of an intra-group borrowing:[83]

> …[Article 9 – Associated Enterprises] is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital…

In other words, Subdivision 815-B arguably permits an analysis of the arm's length nature of the quantum of an Australian taxpayer's related-party debt, absent a specific savings provision.

As Australia's former thin capitalisation rules effectively set boundaries around the quantum of the 'maximum allowable debt', Parliament had not considered it necessary for Subdivision 815-B to traverse similar ground. As such, there has been a specific rule which switched off Subdivision 815-B in relation to the quantum of debt where the existing thin capitalisation rules applied.[84] This rule meant that, in simple terms, when applying the transfer pricing provisions, an entity was required to analyse the arm's length nature of the interest rate as if the quantum of the debt was arm's length, but to apply that interest rate to the actual quantum of debt.

As part of the changes, Parliament has generally limited this specific rule to ADIs and other financial entities that will continue to apply the existing asset-based tests. This means there is no longer this protection for general class investors. Given that the word 'condition' arguably includes the quantum of debt, interest payments on debt exceeding an arm's length quantum of debt may no longer be deductible. In practical terms, this means that most large taxpayers outside of the financial services

[82] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - Final Report*, October 2015, page 19.
[83] OECD, *Model Tax Convention on Income and on Capital,* 21 November 2017, page 227.
[84] See former section 815-140.

industry may be required to evaluate the arm's length nature of the quantum of debt borrowed in respect of all borrowings.

9.2 Practical comments

From a practical perspective, the changes to section 815-140 mean that even where taxpayers are complying with the fixed ratio test (or group ratio test, if applicable), their debt deductions may be disallowed under the transfer pricing provisions.

The requirement to evaluate the arm's length quantum of debt also represents a significant shift in the transfer pricing compliance obligations and dispute risk associated with related-party borrowings. The practical challenge for multinational groups will be how to evaluate the arm's length quantum of debt in the absence of any ATO guidance (such as a practical compliance guideline). The ATO has confirmed it will be providing further guidance to address aspects of the third party debt test, including to address concerns in applying existing guidelines (for example, Practical Compliance Guideline PCG 2017/4 *ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions*). As at the date of this paper, no guidance has been released. (By now, an expected refrain for the reader.)

10. The 'Debt Deduction Creation' Rules

10.1 Introduction

As noted in **section 3.3** above, on 22 June 2023, the Government introduced a new integrity rule – known as the 'Debt Deduction Creation Rule' (or the ***DDCR***). After two rounds of public consultation, and two Senate Committee inquiries, the DDCR was finally passed on 27 March 2024 at the same time as the general thin capitalisation rules.

The introduction of the DDCR came as an unwelcome surprise to taxpayers and their advisors. There was no prior announcement of the measure, and no public (or other) industry consultation on its design prior to June 2023.

The policy objectives of the measure were relatively modest in scope: the Government wanted to disallow debt deductions for schemes under which 'artificial' interest-bearing debt was created within a multinational group which 'lacked genuine commercial justification'.[85] But the design of the DDCR – in its original form – was anything but modest. On the contrary, the Government had introduced a sweeping new integrity rule of alarming breadth. It was supposedly a 'modernised' version of the debt creation rules in former Division 16G of the 1936 Act (but bore little resemblance), and was designed to conform with the areas of risk identified by the OECD in their BEPS Action 4 Report (but went much further than the type of artificial and structured arrangements outlined in that report).[86]

There was very little clarity about what the rules were actually intended to address and why the measure was necessary in light of the existing suite of general anti-avoidance rules, the (modernised) thin capitalisation rules and transfer pricing regime. Instead, the measure would implicate 'legitimate commercial transactions', directly contradicting its intended policy.[87] Most forms of shareholder debt were problematic (there were very limited exceptions/exclusions), transactions across the securitisation industry would become 'economically unviable',[88] and debt deductions on genuine third party borrowings were within scope. The rule was originally supposed to commence on 1 July 2023, without any grandfathering of existing arrangements or transitional provisions.

We are not alone in our criticisms. In the several month window the Government allowed consultation on the proposed measure, many different industry bodies, law firms, accounting firms and other advisors made submissions heavily criticising the original (and subsequent) formulation of the DDCR.

Ultimately, the Government heeded some (but not all) the concerns raised through the consultation process. The DDCR, in the form enacted in Subdivision 820-EAA, contains two – more targeted, but still broadly expressed – limbs. Each limb involves the use of related party debt to either:

- acquire a CGT asset (or legal or equitable obligation) from an 'associate pair' (the ***Acquisition Case***); or

- to fund or facilitate the funding of certain payments or distributions to an associate pair (the ***Payment/Distribution Case***).

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[85] Explanatory Memorandum to the Bill, [2.146] and [2.149].
[86] QIC, *Submission to the Senate Economics Legislation Committee* dated 4 August 2023.
[87] Perpetual Limited, *Submission to the Senate Economics Legislation Committee* dated 15 August 2023.
[88] Australian Securitisation Forum, *Submission to the Senate Economics Legislation Committee* dated 31 July 2023.

Where the DDCR applies, its effect is *severe*: it prevents an entity from claiming a debt deduction paid to an 'associate pair' in relation to the impugned transaction. (Yes, yet another 'associate' concept has been introduced into our tax laws.)

A number of changes were made to the design of the DDCR following the consultation process, but even in the form ultimately enacted some challenging features remain:

- **(No purpose test, and automatic application)** Unlike other specific or general anti-avoidance provisions in the tax laws, it is not necessary to establish an overarching avoidance purpose (eg, to generate debt deductions, or reduce assessable income) and the measure applies *automatically* so it is not predicated on the Commissioner making a determination, requiring taxpayers to self-assess their compliance.

- **(No grandfathering, trading stock in-scope)** Despite the chorus of industry feedback, there is no grandfathering – from 1 July 2024, the DDCR will apply to all arrangements (including, existing arrangements entered into prior to 1 July 2024) – and there is no exclusion for the use of related party funding of trading stock.

- **(Non-bank lenders remain subject to the rules)** ADIs and securitisation vehicles are no longer subject to the DDCR, but non-bank lenders (ie non-ADIs) remain within scope.

- **(Domestic arrangements)** There is no exclusion for purely domestic debt arrangements, and entities which are not subject to the thin capitalisation rules may still be subject to the DDCR.

Thankfully, third party debt is out – and so too are taxpayers who elect to apply the third party debt test for thin capitalisation purposes. But there remain unanswered questions about whether debt deductions incurred on related party debt, generally, are intended to fall foul of the new measure. Some lingering (presumably, unintended) drafting issues also need to be resolved.

The DDCR has its own integrity rule which, unlike the DDCR itself, is predicated on the Commissioner being satisfied of a principal (not dominant) avoidance purpose. Anyone trying to structure around the DDCR, therefore, could find themselves right back within the rules.

10.2 Some preliminary context

The Explanatory Memorandum makes it clear that new Subdivision 820-EAA represents a 'modernised version' of the debt creation rules in former Division 16G of the 1936 Act, and that it is consistent with the BEPS Action 4 Report which recognises the need for supplementary rules to prevent debt deduction creation.

Former Division 16G

Division 16G was originally inserted into the 1936 Act by the *Taxation Laws Amendment Act (No 4) 1988* (Cth). Generally speaking, the Division was designed to deny interest deductions on debt used to fund the transfer of assets from one related company to another where the buyer and seller were at least 50% controlled by a non-resident or related non-residents, subject to certain exceptions.

The Explanatory Memorandum to the *Taxation Laws Amendment Bill (No 4) 1988* summarised the circumstances in which it could apply (emphasis added):[89]

> Clause 50 will insert new Division 16G in Part III of the Principal Act to **deny interest deductions** on **debt creation involving non-residents**.
>
> Division 16G will, in specified circumstances, reduce a deduction which would otherwise be allowable under the Principal Act for interest incurred. The interest affected is that incurred after 30 June 1987 on amounts owing in connection with the **acquisition of assets** from **"foreign controllers" of Australian companies** or from foreign **controlled Australian companies**. Put broadly, restructuring of foreign controlled investments in companies will not be permitted to be financed by interest-bearing debt to the extent that there is **no change in the ultimate beneficial ownership of any assets** transferred under the restructure.
>
> Generally, a **50% capital entitlement test** will determine whether a company has the requisite degree of foreign control to attract the operation of this Division. **As a transitional measure, the required degree of foreign control between 1 July 1987 and 20 June 1988 will be 100%...**
>
> **The aim of the rules is to ensure that there is no increase in the interest-bearing debt where assets are transferred between a related buyer and seller.**

Note a few key things about this passage which immediately distinguishes former Division 16G to the DDCR:

- **First**, former Division 16G was limited to disallowing interest deductions (not 'debt deductions' like under the DDCR).

- **Second**, former Division 16G applied to debt creation schemes involving non-residents. In particular, the Division applied where (i) a non-resident company sold an asset to its Australian resident subsidiary, or (ii) a resident subsidiary sold an asset to the Australian branch of its non-resident parent, or (iii) a resident subsidiary sold an asset to another resident where both had the same foreign controlled. Unlike Division 16G, the DDCR can apply to the sale of an asset by an Australian resident to another Australian resident where neither entity is foreign controlled.

- **Third**, former Division 16G applied to the acquisition of assets only. The application of the DDCR however is not limited to acquisitions of assets (eg, the Acquisition Case can apply to the acquisition of a legal or equitable obligation, and the Payment/Distribution Case can apply in the absence of any acquisition). The DDCR can also apply to the acquisition of trading stock, whereas Division 16G did not apply to an asset that was trading stock, other than when the trading stock was acquired as part of the acquisition of a business.[90]

- **Fourth**, former Division 16G only applied to companies, and not other entities (eg, trusts or partnerships). The DDCR is not limited in the same way.

- **Fifth**, former Division 16G applied a 50% capital entitlement test (rather than the broader 'associate' test under section 318) to determine whether a company was foreign controlled. Where a foreign controller did **not** have a 100% interest in both the buyer and the seller of the asset, the denial of the interest deduction would be reduced proportionally to reflect the

[89] Explanatory Memorandum, *Taxation Laws Amendment Bill (No 4) 1998*, page 83.
[90] Former section 159GZZF(2).

beneficial interests of the foreign controller in the buyer and seller of the asset.[91] The DDCR is not qualified in the same way.

- **Sixth**, former Division 16G initially contained a transitional measure whereby it applied only to wholly owned groups. No such transitional measure has been included in the DDCR.

- **And finally**, under former Division 16G, if, broadly, the Commissioner was satisfied that the acquisition has not and will not result directly or indirectly in an increase in the overall indebtedness of the group, Division 16G did not apply. The DDCR does not confer a similar discretion on the Commissioner.

In July 1999, as part of the Review of Business Taxation (the Ralph Report), there was a recommendation that the thin capitalisation rules should deal with the 'total debt' of an organisation and be broaden to apply to Australian multinational groups.[92] The extension of the rules to Australian multinationals was seen as a method of preventing ‘excessive’ debt being allocated to the Australian operations and so preventing ‘unwarranted’ interest deductions.[93] The comprehensive thin capitalisation regime introduced by the *New Business Tax System (Thin Capitalisation) Bill 2001* meant that Division 16G was, at the same time, repealed.

Case examples of arrangements the DDCR is intended to capture

Treasury is of the view that a specific anti-avoidance rule is, once again, necessary so that the ATO does not have to rely on (the highly resource intensive) general anti-avoidance rules in Part IVA of the 1936 Act to prosecutive egregious debt creation schemes and to also address views apparently held in the tax advisor community that the absence of the debt creation laws since 2001 actually allowed for debt creation schemes to take place in a way that the ATO could not otherwise address without these rules.[94]

In response to a question asked by Senator Smith during the Senate Economics Legislation Committee inquiry, the ATO identified six examples of decided cases that may be covered by the DDCR. Each case involved non-resident associates lending to an Australian entity. The ATO was successful in five of the six cases and where the ATO was successful, three cases were decided on substantive taxation provisions (eg, under the transfer pricing rules), and the other two on the general anti-avoidance rules in Part IVA.

The following cases were identified by the ATO:

Case	Brief Summary of Facts	Key Findings
***Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation* [2021] FCA 1597**	An Australian entity acquired all of the shares in a related entity using financing from an offshore related party.	The Federal Court upheld amended assessments issued by the ATO disallowing substantial deductions claimed by the taxpayer for interest on the financing under Division 13 and Subdivision 815-A (ie on transfer pricing grounds). This was upheld on appeal by the Full Federal Court.

[91] Former section 159GZZE(4).
[92] Review of Business Taxation, Report, July 1999, page 659.
[93] Explanatory Memorandum to the *New Business Tax System (Thin Capitalisation) Bill 2001*, page 3.
[94] Mr Rhys Manley, Assistant Commissioner, Law and Policy Design, Australian Taxation Office, Proof Committee Hansard, 15 August 2023, page 52; Senate Economic Committee Report dated September 2023, [2.105].

***News Australia Holdings Pty Ltd v FCT* [2017] FCA 645**	A parent company borrowed funds from an offshore subsidiary to buy shares in the subsidiary.	The Federal Court ruled in favour of the ATO but the case did not deal with debt deductions, rather when interest was assessable.
***Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092**	Related party debt was used to partly finance the repayment of pre-existing related party debt.	The Federal Court upheld amended assessments issued by the ATO disallowing substantial deductions claimed by the taxpayer for interest on the financing under Division 13 and Subdivision 815-A (ie on transfer pricing grounds).
***Orica Limited v Commissioner of Taxation* [2015] FCA 1399**	Involved related party debt being used to fund payments to an offshore related party which in turn provided those funds back to other Australian members of the group.	The Federal Court upheld amended assessments issued by ATO denying interest deductions on the basis that Part IVA applied.
***Commissioner of Taxation v Consolidated Press Holdings* [2001] 207 CLR 235**	Funds were borrowed from an associate to purchase shares in an associate that did not produce foreign-sourced income	The High Court upheld amended assessments issued by ATO denying interest deductions on the basis that Part IVA applied.
***Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* (1979) 43 FLR 217**	Funds were borrowed from a parent to provide interest-free loans to an associate.	The Full Federal Court allowed the deductions for the taxpayer.

In the case of *Orica*, the ATO noted that the arrangement commenced in 2002 – one year after former Division 16G was repealed. The opportunity to create debt deductions following the repeal of former Division 16G was, supposedly, explicitly recognised by tax advisors at that time.[95]

The ATO was also questioned on their understanding of the scale of the problem. It was unable to provide precise costings. The ATO did, however, refer to Taxpayer Alert TA 2016/10: *Cross-Border Round Robin Financing Arrangements* and indicated that the three examples in that Taxpayer Alert all involved related party transactions that increase debt deductions in Australia.

OECD's BEPS Action 4 Report

The Explanatory Memorandum introducing the DDCR suggests that the DDCR is consistent with the OECD's BEPS Action 4 Report.[96] The Action 4 Report notes that, in certain circumstances, the use of a fixed ratio rule may not be sufficient to prevent base erosion and profit shifting. The OECD recommended that certain countries may wish to consider introducing specific rules to address the following risks:

> … targeted rules may be required to address base erosion and profit shifting risks posed by entities which are not subject to the general interest limitation rules. Even where the fixed ratio rule and group ratio rule apply, a number of specific base erosion and profit shifting risks remain. Therefore, it is recommended that countries consider introducing rules to address the risks listed below:
>
> - An entity which would otherwise have net interest income enters into an arrangement which involves the payment of interest to a group entity outside the country or a related party to reduce the level of interest income subject to tax in the country.
> - An entity makes a payment of interest on an "artificial loan", where no new funding is raised by the entity or its group.

[95] Australian Taxation Office, *Answers to Questions on Notice*, Senate Economics Legislation Committee.
[96] See paragraphs 173 and 174 of that report.

- An entity makes a payment of interest to a third party under a structured arrangement, for instance under a back-to-back arrangement.
- An entity makes a payment of interest to a related party, which is excessive or is used to finance the production of tax exempt income.
- An entity makes a payment of interest to a related party, which is subject to no or low taxation on the corresponding interest income.

Notably, Australia's domestic rules would likely deny a deduction to the entity making the payment in some or all of these examples without the need for any additional specific anti-avoidance rule. For example, where an entity pays interest which is used to produce exempt income or where the payment of interest is subject to no or low taxation, the interest payment would potentially not be deductible under Australia's general deductibility rules, or the entity would be denied a deduction under Australia's hybrid mismatch rules. Similarly, interest payments made on 'artificial loans', or excessive interest generally, would likely be denied a deduction in accordance with Australia's existing general anti-avoidance or transfer pricing rules.

Based on the above, therefore, the OECD's concerns about residual base erosion and profit shifting risks are arguably limited, at least in the examples outlined in the paragraphs above, when having regard to Australia's existing suite of domestic integrity rules. But even if the DDCR still had some residual application, the DDCR (as enacted) lacks a purpose test or other safeguards to ensure that it targets only transactions of particular concern to the OECD, for example, those that 'reduce the level of interest income subject to tax in the country'.

10.3 Who is subject to the DDCR?

A debt deduction of an entity will be denied under the DDCR if the entity is either:

- a 'general class investor'; or
- an outward (or inward) investing financing entity (non-ADI).[97]

The DDCR will **not** apply to an entity where:

- the entity is a 'securitisation vehicle', or an ADI;
- the entity has total debt deductions for the income year of $2m or less;[98]
- the entity qualifies for an exemption as a 'special purpose entity';[99]
- the entity is a qualifying 'Australian plantation forestry entity';[100] or
- the entity chooses the 'third party debt test' will apply.

On the final point, the DDCR is limited to arrangements involving related party debt – as noted above, where an entity chooses to apply the third party debt test, an entity would only be permitted to claim debt deductions where the debt deductions are attributable to genuine third party debt (not related party debt) borrowed against Australian operations and used to fund Australian operations.[101] The

[97] Section 820-423A(1).
[98] Section 820-35.
[99] Section 820-39.
[100] Clause 146 of the Bill ('Saving – old law continues to apply to Australian plantation forestry entities').
[101] Section 820-423A(2)(g) and 820-423A5(f).

DDCR may still apply, however, where an entity has related party debt but has not elected to apply the third party debt test – for example, if the entity wishes to continue apply the fixed or group ratio test (for related party borrowings), or otherwise does not wish to surrender carry forward disallowed FRT deductions.

As noted above, there is no exclusion for purely domestic debt arrangements, and entities which are not subject to the thin capitalisation rules may still be subject to the DDCR. An Australian group is typically exempt from the thin capitalisation rules where the value of all of the 'Australian assets' held by the group is equal to, or greater than, 90% of the value of the total assets of the group.[102] But this exemption has **not** been extended to the DDCR. An entity, therefore, that is not subject to the thin capitalisation rules may still be subject to the DDCR.

This policy seems to originate from the OCED's BEPS Action Item 4 Report where the OECD raised a risk of base erosion and profit shifting in the context of domestic groups which are not subject to the fixed ratio test:

> Where a country does not apply a fixed ratio rule to entities in a domestic group, it will be exposed to base erosion and profit shifting risks, in particular involving interest paid to related parties and third parties under structured arrangements. In this case, a country should consider addressing these risks using targeted rules…[103]

The scope for base erosion and profit shifting would clearly be more limited where interest paid by an Australian borrower is matched by the inclusion of assessable income by an Australian lender (including, for example, where payments are made between entities which are members of a stapled group, or by an Australian borrower to a related group treasury company). A domestic group that is exempt from thin capitalisation under section 820-37 may still enter into arrangements with offshore related parties that generate debt deductions in Australia *without* a corresponding amount being included in the assessable income of an Australian taxpayer. But the overall quantum of this risk would seem to be limited where the interest would remain subject to Australian interest withholding tax and the Australian transfer pricing rules would operate, in any event, to require an arm's length interest rate to be applied to the related party financing. The policy rationale of not extending the exemption under section 820-37 therefore does not seem compelling.

[102] Section 820-37.
[103] See paragraph 51.

10.4 Acquisition Case – Key Threshold Conditions

The key threshold conditions for the first limb (Acquisition Case) of the DDCR can be summarised as follows:

	Threshold Conditions	Comments
Acquisition Condition	An entity (the ***acquirer***) acquires a CGT asset, or a legal or equitable obligation, (directly or indirectly) from one or more other entities (each a ***disposer***)	• The acquisition of a CGT asset (eg, shares in a foreign subsidiary, or business assets following a global merger) will clearly fall within the scope of this condition. • The term 'legal or equitable obligation' is not defined, and there is limited guidance in the explanatory materials about what this phrase is intended to cover. This is an example of a design feature of the rule which is cast broadly but does not seem to have a clear policy basis. It could apply, for example, to an obligation assumed by (i) a borrower under a related party debt arrangement; or (ii) an entity under a financial arrangement eg a fixed to floating swap, or other service arrangement eg an insurance contract; or (iii) an entity under an option, or a lease.[104] A number of submissions to Treasury called for additional clarity about the scope of this phrase, particularly if it is intended to limit debt deductions incurred on the assumption of an obligation under ordinary related party debt. • The existing definition of 'acquire' in section 995-1 is intended to apply but that definition is limited to acquisitions of 'CGT assets' and items of 'intellectual property'. The definition does **not** appear to be modified to extend to the acquisition (or assumption) of 'legal or equitable obligations'. In the absence of any such modification, the inclusion of the acquisition of 'legal or equitable obligations' would appear otiose, a result which the courts would be reluctant to endorse: *Project Blue Sky Inc. v Australian Broadcasting Authority* (1998) 194 CLR 355 at 382. The definition of acquire is, however, modified to disapply paragraph (b).[105] The effect of that modification is that an entity will be taken to acquire an item of intellectual property where a licence relating to a patent, design or copyright is surrendered to the entity.
Disposer Condition	One or more of the disposers must be an 'associate pair' of the acquirer (***associate disposer***)	• The term 'associate pair' is defined (in section 995-1) to mean an entity which is an 'associate' (under the existing framework of section 318 of Tax Act) of the other entity, or the other entity is an 'associate' of the entity – under section 318, it is possible (in theory) for A to be an 'associate' of B, but not vice versa. The rule applies regardless of the residency of either entity. • There is some uncertainty about when a disposer must be an 'associate pair' of the acquirer – whether, for example, the relationship is tested at the time of the acquisition, or when the relevant debt deduction is claimed.

[104] See the 'Corporate Tax Association' (CTA) Submission to Treasury on the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (Bill)* dated 1 November 2023.
[105] Section 820-423A(4).

		• The definition of 'associate pair' is modified for certain unit trusts so that, broadly, when applying the existing definition of associate under section 318 a unit trust is treated as if it were a company.[106] Absent this modification, an entity could be an associate of a unit trust – that is not a 'public unit trust' – simply because it is a unitholder (or beneficiary) of the trust. • Relatedly, the 'sufficiently influenced' test is also modified to apply when determining whether a trust is an associate of another entity (or another entity is an associate of the trust). There is also a modification of the 'majority voting interest' test but only insofar as it is relevant to determine whether a trust is 'sufficiently influenced', but not for the purposes of determining whether an entity, itself, holds a majority voting interest in the trust.[107] A limited safeguard – awkwardly drafted – is included to seemingly ensure that the sufficiently influenced test is not satisfied merely because of a breach to the terms of a debt interest issued (or held) by the trust to protect the interests of secured creditors.[108]
Who is claiming the debt deductions?	The entity claiming the debt deductions (the ***relevant entity***) must be the acquirer (or an associate pair of the acquirer) or an associate pair of an associate disposer	• The entity claiming the relevant debt deductions for the 'acquisition' may be an entity other than the acquirer itself – eg, it may be the parent of the acquirer.
What are the debt deductions for?	The debt deductions must, wholly or partly, be in relation to the acquisition, or the 'holding' of the CGT asset, or legal or equitable obligation	• A nexus must exist between the debt deductions incurred and the acquisition of the CGT asset (or legal or equitable obligation), or the holding of such asset or obligation. Where, for example, a taxpayer's related party debt is pooled with third party debt, the taxpayer would need to determine the extent to which the debt deductions for the related party debt are, wholly or partly, in relation to the acquisition of the CGT asset (or obligation). • There is no guidance in the Explanatory Memorandum about how a taxpayer should test whether a nexus is established – we expect some taxpayers would probably undertake (a likely complex, and laborious) exercise of tracing funds.
Related party debt condition	The debt deduction must be referrable to an amount paid or payable, directly or indirectly, to an associate pair of (i) the relevant entity, (ii) the acquirer or (iii) an associate disposer	• The effect of this condition is to limit the operation of the DDCR to debt deductions incurred on related party debt only (not third party debt) – it was conspicuously absent from the original form of the DDCR.

[106] Section 840-423E.
[107] Section 840-423E(4)(b)
[108] Section 820-423E(6).

Exclusions	The acquisition of certain CGT assets are **excluded** from the scope of the rule	• The acquisition of the following CGT assets are specifically *excluded* from the scope of the Acquisition Case:[109] o the acquisition of new membership interests in an Australian entity, or a foreign entity that is a company (it is not clear why this exclusion does not also extend to the acquisition of new membership interests in a foreign entity that is not a company (eg, a foreign trust or partnership)); o the acquisition of a 'depreciating asset' (other than an intangible asset) that is held and, at the time of acquisition, (i) is expected to be used by the acquirer for a taxable purpose in Australia within 12 months; and (ii) has not been installed ready for use, or previously used for a taxable purpose by the acquirer, associate disposer or associate pair of the acquirer – this exception is intended to allow an entity to bulk-acquire tangible depreciating assets on behalf of its associate pairs; and o the acquisition of 'debt interest' by an acquirer which is issued by an associate pair of the acquirer – ie related party debt *held* or *lent* by an entity (rather than *issued* or *borrowed* by the entity). • Notably, there is no exclusion for the acquisition of trading stock (notwithstanding that a comparable exclusion existed under former Division 16G of the 1936 Act). According to Treasury, an entity that does **not** have sufficient funds to purchase day-to-day inputs is likely to be reflective of a 'thinly capitalised' entity and this is what the rules are intended to target.[110] As a practical matter, this will mean, for example, that debt deductions for interest accruing on outstanding intercompany payables for trading stock purchases will be disallowed. • There are specific rules which apply to indirect acquisitions where one of the acquisitions is covered by an exception[111] – if, for example, a parent entity borrows to subscribe for new shares in a subsidiary (which, of itself, would be outside the scope of the Acquisition Case), but the subsidiary uses the funds to acquire another asset from an associate, there may be an indirect acquisition of the asset which implicates the Acquisition Case rule by the parent entity. • The Explanatory Memorandum makes it clear that the acquisition of Australian currency is generally **not** expected to fall within the scope of the provision (on the basis that such currency is not a CGT asset when it is used as legal tender).[112] The acquisition of 'cash' was a specific carve out under former Division 16G which referred to the acquisition of 'assets' generally, rather than 'CGT assets'.[113]
Third Party Debt Test	The relevant entity has not made a choice to use the third party	• As mentioned above, where the entity claiming the debt deduction has made a choice to apply the third party debt test under the thin capitalisation rules, the DDCR will not

[109] Section 820-423AA.
[110] See Treasury Submission to the Senate Committee on Economics dated 5 January 2024.
[111] Section 820-423A(3A).
[112] See Supplementary Explanatory Memorandum, [1.40].
[113] Section 159GZZF(1).

	debt test for the income year	operate to deny the entity any debt deductions but the entity will, of course, be unable to claim the debt deductions for related party debt under the thin capitalisation rules in any event because the debt deductions would not be for genuine third party debt.

10.4.1 What is the quantum of the debt deduction disallowed?

Where each of the conditions for the Acquisition Case are satisfied, a debt deduction incurred by an entity is disallowed under section 820-432A(1) to the extent that the debt deduction was incurred on the acquisition of the CGT asset (or legal or equitable obligation) or the holding of such CGT asset (or obligation).[114]

10.5 Payment/Distribution Case – Key Threshold Conditions

The key threshold conditions for the second limb (Payment/Distribution Case) of the DDCR can be summarised as follows:

	Threshold Conditions	Comments
Financial arrangement	The payer enters into or has a 'financial arrangement' with another entity	• The term 'financial arrangement' is defined under the 'taxation of financial arrangement' (***TOFA***) rules in Division 230 of the 1997 Act. The use of the phrase 'financial arrangement' rather than 'debt interest' is a deliberate design feature of this limb, and is intended to align with the new definition of 'debt deduction' under section 820-40 which recognises that a debt deduction may be incurred in relation to various financial arrangements (including debt interests).[115] • Cash settlable financial arrangements or equity interests (eg, loans, notes, bonds, debentures, shares, units, options etc) are financial arrangements that would generally satisfy this condition (it would, of course, also satisfy the first condition of the Acquisition Case). Direct investments in real property, plant and equipment or other tangible assets would generally not be 'cash settlable' arrangements or equity interests and therefore would not be a 'financial arrangement' for the purposes of this condition. • The financial arrangement may be entered into with the recipient of the payment or distribution, or any other entity.[116]

[114] Section 820-423B(1).
[115] Broadly, an arrangement will be a 'financial arrangement' under the TOFA rules if the taxpayer has, under the arrangement, a 'cash settlable' legal or equitable right (or obligation) to receive (or provide) a financial benefit but does not also have under the arrangement one or more not insignificant non-cash settlable legal or equitable rights (or obligations) to receive (or provide) something: section 230-45(1). A right or obligation is 'cash settlable' where, broadly, the relevant financial benefit is money or a money equivalent or the parties intended or have a practice of settling their rights or obligations by receiving or providing money or a money equivalent: section 230-45(2). An equity interest is also a financial arrangement: section 230-50(1).
[116] Section 820-423A(6)(b).

Use of financial arrangement	The payer uses the financial arrangement to fund, or facilitate the funding of, one or more payments or distributions that *to an extent* is (i) made to an associate pair of the payer (an ***associate recipient***); and (ii) is a payment or distribution of a type that is prescribed (ie covered by subsection (5A))	• This is one of the key conditions under the Payment/Distribution Case. It may be satisfied where the financial arrangement is used to fund or facilitate the funding of a payment or distribution which, *to any extent*, is made to an associate recipient **and** is a prescribed payment. • Under a previous formulation, the condition required proceeds to be 'predominantly' used to fund the relevant payment or distribution – this is no longer required, and therefore, if *any* part of the financial arrangement is used to fund a payment/distribution to an associate pair, the condition could be satisfied (NB: the debt deduction which is denied under section 820-423B(2) is still calculated on a proportionate basis (see below)).[117] • One of the key changes to this condition was to reformulate the type of 'payments' and 'distributions' that would be impugned. Treasury's initial formulation was to cast the net wide – by reference to a payment or distribution within the meaning of section 26BC of the 1936 Act – and with limited carve outs. Following feedback, the final form of the measure contains a more targeted and defined list of payments and distributions.[118] These include, broadly: o a dividend, distribution (eg, the 'dividend component' of certain off-market share buy-backs), non-share distribution or return of capital (including by a company, trustee or partnership); o a payment/distribution to cancel or redeem a membership interest in an entity; o a royalty, or similar payment/distribution for the use (or right to use) an asset; o a payment or distribution that is referable to the repayment of principal under a debt interest issued by the payer which itself was, broadly, used to fund or facilitate the funding of a prescribed payment or distribution; o a payment or distribution of a 'kind similar' to the above – there is no guidance on what a similar kind of payment or distribution would include; and o a payment or distribution prescribed by the regulations – no such payment or distribution is currently prescribed. • The Payment/Distribution Case of the DDCR appears to displace the general law position accepted by Hill J in *Commissioner of Taxation v Roberts; Smith* (1991) 37 FCR 246 which confirmed that replacing the funds invested in a business with borrowed moneys should give rise to an allowable deduction for the interest payable on the borrowed funds. • For the payer to 'facilitate the funding' of a payment or distribution, there must be a connection – an indirect connection will be sufficient[119] – between the use of the

[117] Moreover, under a previous formulation, the focus of the rule was on the 'proceeds' from the financial arrangement – the condition is now intended to focus on the use of the financial arrangement including how that use might change over time: see paragraph 1.48 of the Supplementary Explanatory Memorandum.
[118] See Supplementary Explanatory Memorandum, [1.46].
[119] Without necessarily establishing that each payment in a series of payments funds the next, or is made after the previous payment: see section 820-423A(7).

		financial arrangement and the funding of the payment or distribution.[120] The permitted or allowed purpose (or usage) of the financial arrangement may be considered as part of this condition.[121] • This feature of the Payment/Distribution Case makes the scope of the measure subject to considerable uncertainty – for example: o Is it acceptable for shareholder debt to be used to fund a payment to a third party? o What if third party debt is separately used to make a relevant payment or distribution at the same time – does that mean debt deductions on the shareholder debt are denied? o What if the entity had sufficient cash reserves to make the payment or distribution, without any debt, and those reserves were actually used to fund the payment/distribution, or the quantum of the shareholder debt was significantly less than the quantum of the payment/distribution? Does that mean debt deductions on the shareholder debt are allowed? • Submissions have already been made to the ATO requesting detailed administrative guidance on the meaning of ' facilitate the funding of', including the ATO's approach to tracing (and related record keeping requirements) and the types of arrangements the Commissioner would consider to be high, medium or low risk.[122] The ATO has indicated that it will consider providing compliance guidance on tracing and apportionment issues relating to historical debt arrangements for the purposes of applying the DDCR, subject to 'stakeholder engagement and submissions'.[123] It has not confirmed the position regarding new debt arrangements.
Who is claiming the debt deductions?	The entity claiming the debt deductions (the ***relevant entity***) must be the payer (or an associate pair of the payer) or an associate pair of an associate recipient	• Similar to the Acquisition Case: o the entity claiming the relevant debt deductions may be an entity other than the payer itself – eg, it may be the parent of payer; o a nexus must exist between the debt deductions incurred and the financial arrangement which funds, or facilitates the funding of, the relevant payment or distribution; o the operation of the Payment/Distribution Case is limited to debt deductions incurred on related party debt only (not third party debt); and
What are the debt deductions for?	The debt deductions must, wholly or partly, be in relation to the financial arrangement	

[120] Under a previous formulation, the condition could have been satisfied if some or all of the proceeds were used to 'increase the ability of any entity' to make the payment/distribution – based on this condition, any time related party debt contributed to a pool of funds available to a taxpayer (even where it was not necessarily used for a prohibited payment/distribution), that could have implicated this condition. This feature has now been removed.
[121] See Supplementary Explanatory Memorandum, [1.49].
[122] The Tax Institute, *Amendments to the thin capitalisation rules – ATO's Public Advice and Guidance Consultation*, dated 22 March 2024.
[123] See [Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation | Australian Taxation Office](#).

Related party debt condition	The debt deduction must be referrable to an amount paid or payable, directly or indirectly, to an associate pair of (i) the relevant entity, (ii) the payer or (iii) an associate recipient	o where the entity claiming the debt deduction has made a choice to apply the third party debt test under the thin capitalisation rules, the DDCR will not operate to deny the entity any debt deductions.
Third Party Debt Test	The relevant entity has not made a choice to use the third party debt test for the income year	

10.5.1 What is the quantum of the debt deduction disallowed?

Where each of the conditions for the Payment/Distribution Case are satisfied, the amount of a debt deduction incurred by an entity which is disallowed under section 820-432A(1) is equal to the same extent as the extent to which the payer uses the financial arrangement to fund, or facilitate the funding of, one or more prescribed payments or distributions to the associate recipient.[124] In other words, debt deductions are denied on a proportionate basis.[125]

10.6 The anti-avoidance rule

The DDCR includes a specific anti-avoidance rule.[126] In particular, if the Commissioner is satisfied that it is reasonable to conclude that one or more entities entered into or carried out a relevant scheme for the principal purpose of, or for more than one principal purpose that included the purpose of, ensuring there are no denials of debt deductions under either the Acquisition Case or the Payment/Distribution Case of the DDCR, the Commissioner may determine that the provisions would apply.

Treasury has helpfully confirmed that the specific DDCR avoidance rule is **not** intended to apply to schemes where a taxpayer is merely restructuring out of an arrangement that would otherwise be caught by the DDCR:[127]

> …these rules are not intended to apply to schemes where a taxpayer is **merely restructuring**, without any associated artificiality or contrivance, out of an arrangement that would otherwise be caught by the debt deduction creation rules.

Similar to the position for the general thin capitalisation rules, the ATO has also signalled that it would not be looking to apply this (or other) integrity rules for legitimate restructurings:

> …we're really mindful that taxpayers will need to manage the transition from the current thin capitalisation regime to the proposed new thin capitalisation regime on passage of the bill, and this may well require restructuring of existing financing arrangements. We're also mindful that there are some concerns within the stakeholder groups about whether that restructuring might fall foul of integrity rules,

[124] Section 820-423B(2).
[125] See Explanatory Memorandum, [1.50].
[126] Section 820-423D.
[127] Supplementary Explanatory Memorandum to the Bill, [1.44].

> not just in the measure itself but also more generally. What I'll say about that is that, **as a general principle, the ATO would not be looking to apply integrity rules in the proposed new law or elsewhere where taxpayers are restructuring their arrangements as a means of seeking to comply with the underlying intent of the new law**. This is an approach we have taken in the past.[128]

More recently, the ATO has confirmed that it will provide, as a high priority issue, compliance guidance on the Commissioner's application of Part IVA and the specific anti-avoidance provision on certain restructures in response to the new law.[129]

10.7 Potential scope of the DDCR – some practical examples

Part of the difficulty in understanding the intended scope of the DDCR is that the Explanatory Memorandum offers no examples. We have therefore designed some hypothetical examples to explore its potential application. The examples involve a hypothetical taxpayer, 'Waystar', with the following background facts:

- Waystar, run by an eccentric and ruthless patriarch (and octogenarian), is listed on the NASDAQ. Waystar's key asset is a streaming platform – StarFlix.
- Waystar operates in Australia through a wholly owned subsidiary, Kendal Co Pty Ltd. The subsidiary is managed locally by the eldest son of the Waystar family who carries the weight of the corporate empire on his shoulders.
- Kendal Co is a general class investor under the thin capitalisation rules, and **has** not made a choice to apply the third party debt test.

10.7.1 Scenario 1 – acquisition of StarFlix

- In 2020, Kendal Co acquired all the shares in StarFlix from Waystar for $14 billion.
- Kendal Co funded the acquisition by issuing $9 billion of shares, and $5 billion of (interest-bearing) loan notes, to Waystar.
- Kendal Co claimed interest deductions on the loan notes.

Potential application of the DDCR

- From 1 July 2024, the debt deductions incurred by Kendal Co on the loan notes would likely be denied under the Acquisition Case limb of the DDCR on the basis that: (1) Kendal Co acquired shares (a CGT asset) from its parent company, and associate pair, Waystar; (2) Kendal Co would, in the absence of the DDCR, claim a debt deduction for interest paid to Waystar (on the loan notes); and (3) the acquisition of existing shares in a company is **not** covered by an exception.
- This is not dissimilar to the facts in the *Singtel Case* (discussed above). There, the Court upheld amended assessments issued by the ATO disallowing substantial deductions claimed by the

[128] Mr Ben Kelly, Deputy Commissioner, Australian Taxation Office, Proof Committee Hansard, 31 January 2024, p 18.
[129] See [Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation | Australian Taxation Office]

taxpayer for interest on the financing under Division 13 and Subdivision 815-A (ie on transfer pricing grounds). On similar facts, the DDCR would operate to deny the taxpayer debt deductions on the related party financing used to acquire the shares.

10.7.2 Scenario 2 – acquisition by GoJo

- Waystar has been in financial difficulty, and after protracted (and animated) negotiations with up-and-coming internet sensation, Lukas Matsson, and his company, GoJo, Waystar agrees to merge with GoJo. GoJo would acquire Waystar.

- GoJo is a Swiss company without any existing Australian operations. So first, GoJo decides to set up an Australia 'Matsson HoldCo / Matsson BidCo' structure to acquire all the shares in Kendal Co.

- GoJo has burnt most of its cash on exotic employee retreats in the Nordics and legal fees on ongoing regulatory investigations. So, it has decided to source funding for the Waystar acquisition from Suisse Bank, and to the extent of any shortfall, raise capital from the Mattson Family (its majority shareholder).

- GoJo on-lends some funds to Matsson BidCo, as related party funding, to acquire the shares in Kendal Co. The funding is interest bearing. Matsson HoldCo claims interest deductions on the debt.

Potential application of the DDCR

- Under this scenario, the key question would be whether Matsson HoldCo acquired shares (a CGT asset) in Kendal Co from an 'associate pair' – ie Waystar. As discussed above, under the Acquisition Case, there some uncertainty about when a disposer must be an 'associate pair' of the acquirer – whether, for example, the relationship is tested at the time of the acquisition, or when the relevant debt deduction is claimed.

- If, for example, the relationship is tested at the time of acquiring the relevant CGT asset, the sequencing of the transaction may be important:

    - if the shares in Kendal Co were acquired from Waystar **after** GoJo acquired Waystar, Waystar would clearly be an 'associate pair' of Mattson BidCo because each company would be wholly owned by GoJo; but

    - if the shares in Kendal Co were acquired from Waystar **prior** to GoJo acquiring Waystar, ostensibly, Matsson HoldCo would have acquired the shares from an unrelated entity. There would be a risk, however, that Waystar would be 'sufficiently influenced' by Matsson HoldCo or its associates (GoJo) where Waystar was the subject of an unconditional but uncompleted agreement (or merger). If so, Waystar would be an 'associate pair' of Matsson BidCo. Even if that is not the case, the specific DDCR anti-avoidance rule under section 820-423D would need to be considered in light of the sequencing of the transaction to determine whether the Acquisition Case would apply, in any event, to disallow the debt deductions.

- This is not dissimilar to the facts in the *Mylan Australia Holding Pty Ltd v Commissioner of Taxation (No 2)* [2024] FCA 253. There, the Federal Court concluded that Part IVA did not apply on the basis that the taxpayer was able to establish the absence of a sole or dominant purpose of obtaining a tax benefit. On similar facts, the DDCR would now need to be carefully considered.

10.7.3 Scenario 3 – related party working capital facility

- A few years after the successful takeover of Waystar, Mattson HoldCo enters into an (interest-bearing) working capital facility with GoJo ($400m) to fund ongoing business expenditure. (The initial acquisition funding was capitalised).

- Mattson HoldCo also has some excess cash ($500m) and profits generated from running a more agile business (with less frequent, and shorter, private jet itineraries). Mattson HoldCo decides to declare and pay a dividend to GoJo ($500m) funded by existing cash.

- Matsson HoldCo claims interest deductions on the working capital related party debt.

Potential application of the DDCR

- It is unclear whether the debt deductions incurred by Matsson HoldCo on the related party debt may be denied under the Payment/Distribution Case limb of the DDCR – this will depend on the scope of the phrase 'facilitate the funding of' in subsection 820-423A(5)(b(ii). This is because, (i) Matsson HoldCo has entered into a related party loan (ie a financial arrangement) with GoJo; (ii) it has used the related party loan to fund ('good') business expenditure, but query whether the related party funding has 'facilitated' the payment of the ('bad') dividend by creating additional capacity for Matsson HoldCo to use its existing cash to actually fund the dividend; and (iii) Matsson HoldCo has claimed debt deductions on the related party loan, which is paid to GoJo, an associate pair of Matsson HoldCo.

- ATO guidance in this context is expected to be forthcoming. Ultimately, clear and contemporaneous documentation to evidence the source of funding the payment of the dividend will be critical.