Challis Discussion Group

Thin Capitalisation – BEPS with some add-ons

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1 November 2023

1 Introduction

NOTE TO TREASURY

I have prepared this paper to be given at the Challis tax discussion group on 1 November 2023. The paper sets out my thoughts on the background to and various aspects of the proposed new thin capitalisation rules. Although not written as a submission, there are some points noted in this paper that may be of interest to Treasury in considering the latest draft provisions. I would particularly note the comments in sections 8 and 9 below in relation to the debt creation rules and timing / transitional provisions.

As noted below, the views in the paper are mine alone – and are not reflective of either the views of my firm or alternatively the Challis group or its members.

I will start by noting that the views (and any mistakes) in this paper are mine and are not reflective of the views of anyone else.

The Government announced in October 2022 that the thin capitalisation provisions would be amended. These amendments are part of the OECD driven BEPS changes – many of the other BEPS measures having been introduced into the Australian tax system over the last few years.

The process for the introduction of the provisions has been a journey – and it's still not finished. In summary:

- The Government announced the changes in October 2022.
- Draft legislation was released in March 2023. The start date of the legislation was income years commencing on or after 1 July 2023.
- A consultation process was undertaken. The submissions were wide-ranging and extensive – with particular concerns in relation to the new third-party debt test and the repeal of s.25-90 (and the TOFA equivalent).
- A revised set of draft provisions was introduced into Parliament in June 2023. As well as still containing many areas of concern for taxpayers, the revised draft rules also contained new 'debt creation' anti-avoidance provisions. Although stated to be anti-avoidance provisions, the legislation did not contain any of the usual anti-avoidance 'purpose' tests. The repeal of s.25-90 was removed from the Bill.
- The Senate referred the Bill to the Senate Economics Committee (in June 2023).
- The Senate Economics Committee issued a report on the Bill in September 2023. Although the report recognised that further technical amendments were necessary, little detail was provided. The committee recommended that the provisions were enacted with a start date of 1 July 2023.
- At the same time, the Coalition Senators issued a dissenting report which recommended a number of things including the removal of the debt creation rules (they suggested that they should be the subject of separate consultation) and the deferral of the start date of the general provisions to 1 July 2024.
- On 18 October 2023, Treasury released further revised draft legislation which contain a number of proposed amendments – largely to address some of the issues raised by industry. Treasury has given industry a further two weeks to make submissions.

As such, we appear to have what is likely to be close to a final set of provisions.

In this paper, I have not attempted to cover all of the new provisions, Rather, I have attempted to focus on a few areas that hopefully will be of interest to the group.

In writing this paper, I re-read a paper that Professor Richard Vann gave in 1988 on thin capitalisation proposals. Professor Vann stated:

> *"When we turn to the international area, the problem of thin capitalisation still persists for two reasons - the continuance of the classical system of company taxation for non-resident shareholders because of the denial of imputation credits to them and the low rate of tax on interest income paid to a non-resident without a permanent establishment in Australia (under domestic law and treaties the tax rate is 10% gross on the interest if the interest is taxed at all).*
>
> *The obvious way to attack the problem is to level the international laying field by having similar rates of tax on debt and equity but the current treatment is the entrenched international norm and therefore in the short term is unlikely to be changed. It thus becomes necessary to adopt indirect measures to deal with the problem and the thin capitalisation legislation is to be seen in this context. There are two basic approaches to the issue - one uses fixed ratios and the other takes a case-by-case approach - looking at the characteristics of the investment involved. 5 Australia has opted for the first of these.*
> *In the medium to long term this is simply one of the many areas that will spell the end of the current international tax norms and produce a multilateral international approach to tax laws, that is, agreed international parameters on national tax systems and the treatment of such issues through an international forum similar to the General Agreement on Tariffs and Trade. The current work of the 0.E.C.D. which is directed to ensuring that the current system continues to function is the forum where this trend is already becoming noticeable."*
>
> (Professor Richard Vann, Sydney University – speaking at the International Tax Workshop of the University of New South Wales, Taxation Business and Investment Law Research Centre, August 1988)

Professor Vann's final comments in relation to the development of international norms and the role of the OECD have proved to be particularly pertinent.

One important change that I will not cover in this paper is the change to the thin capitalisation / transfer pricing interactions (for non ADIs and financial entities) such that the quantum of debt (as well as the pricing of debt) will be subject to the transfer pricing rules even if the interest is deductible under the thin capitalisation rules (previously, if the amount of debt was permitted under the thin capitalisation rules then there was no need to separately test the amount of debt under the transfer pricing rules).

2 OECD Action Item 4

2.1 General

Action Item 4 of the OECD BEPS project is entitled 'Limiting Base Erosion Involving Interest Deductions and Other Financial Payments'.

Action Item 4 concludes that base erosion risks may arise in three basic scenarios being:

- Groups having higher levels of third-party debt in high tax countries.
- Groups using intra-group loans to create interest deductions in excess of the group's third-party interest expense.
- Groups using debt (third party or intragroup) to fund the generation of tax-exempt income.

The OECD's 2016 Update (the **OECD Report**) provides the following basic examples to illustrate some of these issues:

Box 1. Example of the impact of tax on the location of interest expense*

These examples assume no restriction on the ability of a group to obtain deductions for its interest expense, for example under transfer pricing or thin capitalisation rules.

Outbound investment

Consider a simple group structure, including two companies (A Co and B Co). A Co is resident in a country with a 35% rate of corporate income tax, which exempts foreign source dividends from tax. B Co is resident in a country with a 15% corporate tax rate.

B Co borrows USD 100 from a third party bank at an interest rate of 10%.** B Co uses these funds in its business and generates additional operating profit of USD 15. After deducting the USD 10 interest cost, B Co has a pre-tax profit of USD 5 and a post-tax profit of USD 4.25.

Alternatively, A Co could borrow the USD 100 from the bank and contribute the same amount to B Co as equity. In this case, B Co has no interest expense and its full operating profit of USD 15 is subject to tax. B Co now has a pre-tax profit of USD 15 and a post-tax profit of USD 12.75. Assuming A Co can set its interest expense against other income, A Co has a pre-tax cost of USD 10 and a post-tax cost of USD 6.50. Taken together, A Co and B Co have a total pre-tax profit from the transaction of USD 5 and a total post-tax profit of USD 6.25.

As a result of transferring the interest expense from B Co to A Co, the group is now subject to a negative effective rate of taxation (i.e. the group's post-tax profit exceeds its pre-tax profit).

Inbound investment

A similar result can also be achieved in an inbound investment context.

In this case, A Co is resident in a country with a 15% rate of corporate income tax and B Co is resident in a country with a 35% corporate tax rate.

B Co borrows USD 100 from a third party bank at an interest rate of 10%. B Co uses these funds in its business and generates additional operating profit of USD 15. After deducting the USD 10 interest cost, B Co has a pre-tax profit of USD 5 and a post-tax profit of USD 3.25.

A Co could also replace USD 50 of existing equity in B Co with a loan of the same amount, at an interest rate of 10% (the same rate as on the loan from the third party bank). In this case, B Co has a pre-tax and post-tax profit of nil. A Co has interest income on its loan to B Co, and has a pre-tax profit of USD 5 and a post-tax profit of USD 4.25. The group has reduced its effective tax rate from 35% to 15% by shifting profit from B Co to A Co.

Box 1. Example of the impact of tax on the location of interest expense *(continued)*

Taking this one step further, A Co could replace USD 100 of existing equity in B Co with a loan of the same amount. Assuming B Co can set its interest expense against other income, as a result of this transaction B Co now has a pre-tax loss of USD 5 and a post-tax loss of USD 3.25. A Co receives interest income from B Co, and has a pre-tax profit of USD 10 and a post-tax profit of USD 8.50. Taken together, A Co and B Co have a pre-tax profit of USD 5 and a post-tax profit of USD 5.25. As a result of thinly capitalising B Co and shifting profit to A Co, the group is now subject to a negative effective rate of taxation.

* The first part of this example is adapted from Graetz (2008).

** All monetary amounts in this example are denominated in United States dollars (USD). This is an illustrative example only, and is not intended to reflect a real case or the position in a particular country.

When you look at the examples, it is easy to understand the concern. However, the issue is also partly driven by the difference in tax rates between jurisdictions – international taxpayers are always likely to have a preference to have greater amounts of debt in jurisdictions where tax rates are higher. This is a particular issue for Australia having regard to its corporate tax rate, which is significantly higher than many other countries, including most OECD jurisdictions.

The OECD's recommended solution to these problems is for a country's thin capitalisation provisions to be based on a fixed income ratio which limits an entity's debt deductions to a percentage of its earnings before interest, tax, depreciation and amortisation (**EBITDA**).

The OECD Report acknowledges that most thin capitalisation provisions have historically been based on rules based on the debt / equity mix in an entity, which the Report recognises has provided a level of certainty to taxpayers.

The primary reasons for the recommendation of an EBITDA based approach arose from concerns that:

- a debt / equity test does not prevent higher interest expenses through increasing the interest rate on the debt; and
- an equity-based test allows companies to 'manipulate' outcomes by increasing the level of equity in a particular entity.

The main benefit of an EBITDA approach was the link that is created between debt deductions and the activities which generate taxable income. This link was also seen as reducing the ability for tax planning as, in order to increase thin capitalisation capacity, income in an entity / country would also need to increase.

The obvious disadvantage is the volatility and uncertainty that is created through the link to earnings – for instance consider (i) those projects where there is significant investment up front with earnings or profit only being derived after many years or (ii) businesses whose earnings fluctuate significantly.

The OECD Report recognises some of these concerns noting that countries may wish to:

- introduce rules which permit entities to carry forward both (i) disallowed interest expenses and (ii) unused interest capacity; and
- exempt certain entities or projects – for instance, privately-owned public sector projects which may typically be financed with large amounts of debt. The OECD Report recognises that there should be little base erosion risk in such projects.

There was also a clear desire to try and provide a more uniform position across the international tax system so that arbitrage opportunities are not created as a result of different countries applying different thin capitalisation tests.

As with any self-respecting tax report, there was also a recognition that the general rules may need to be accompanied by targeted anti-avoidance rules.

2.2 Interest

The OECD Report recommends that the rules apply to interest, payments economically equivalent to interest and expenses incurred in connection with the raising of finance.

The OECD Report recommends that this should include items like:

- payments under profit participating loans;
- finance lease payments – the finance component of the rental;
- notional interest amounts under derivatives related to borrowings; and
- potentially certain foreign exchange gains and losses – where they are connected to the raising of finance.

2.3 EBITDA

We will discuss this in greater detail later in the paper in relation to the Australian rules. However, a few initial points that are worth noting from the OECD Report:

- The Report recommends that only net interest (rather than gross interest) is taken into account.

  For instance, assume an entity has $100 of interest income and a $90 interest expense – in this fact pattern, it is only the $10 of net interest income that should be taken into account (both in determining EBITDA and also in considering what debt deductions may be denied under the rules).

  The primary reason for this is to ensure that there is not a double taxation of interest income when it flows up a chain – when part of the gross interest expense is denied.

- When determining the 'earnings' of an entity, certain types of income that are exempt or non-assessable should be excluded – the classic examples of this being income derived from a branch (when a branch profits exemption applies) and dividends derived from an overseas subsidiary (where a non-portfolio participation exemption applies).

  Australia already had similar concepts in its existing thin capitalisation provisions. We will discuss s.25-90 in greater detail in section 3 below.

- One option to partially overcome volatility was to use average earnings figures over a three-year period, rather than looking at earnings on a single year basis. The OECD Report recognised this as an option available to countries. Australia has not adopted this approach.

2.4 Group ratio rule

The OECD Report recommended that countries adopt a group ratio rule to sit alongside the fixed ratio rule.

The purpose of the rule is to allow entities that have a significant degree of leverage in a particular country (i.e., they would be denied deductions under the fixed ratio rule) to apply a group rule that would look at the financial ratios of the worldwide group.

Australia has introduced such a group ratio rule to sit alongside the primary fixed ratio rule. I have not considered the group ratio rule in this paper.

2.5 Banking and Insurance

The OECD Report recommends that banks and insurance companies are not subject to the EBITDA based tests. The principal reasons for this are:

- Banks and insurance companies hold financial assets and liabilities as a key or integral part of their businesses (for instance, for banks their main assets and liabilities are loans).
- Banks and insurance companies are subject to prudential regulation which imposes strict requirements on their capital structures (e.g., Basel III for banks and the Solvency II Directive for European insurers). Typically, most of these companies will be well capitalised.

The OECD Report notes that any exclusion that applies to banks and insurance companies should not apply to treasury companies, captive insurers or any other non-regulated entities.

Australia has carved banks (ADIs) and other financial entities out of the new rules – they will continue to be subject to the ADI and financial entity rules (for both inward and outward entities) that exist in the current thin capitalisation rules.

Insurance companies will be subject to the new rules – consistent with the fact that there are no specific rules for insurance companies in the current rules.

3 Section 25-90

When the draft legislation was originally released in March 2023, the item that took everyone by surprise was the repeal of s.25-90 (and its TOFA equivalent in s.230-15(3)).

The draft explanatory memorandum stated in relation to the repeal of s.25-90:

> *"Section 768-5 of the ITAA 1997 deems certain foreign equity distributions as non-assessable non-exempt (NANE) income of an entity. At the same time, sections 25-90 and 230-15 of the ITAA 1997 provide that interest expenses incurred to derive this NANE income are deductible. This is contrary to the general rule in Australia's tax system which provides that expenses incurred in deriving NANE income are non-deductible.*
>
> Additionally, the policy intent of the new earnings-based tests is to limit the amount of deductible interest expense by reference to earnings - that is, an entity is only able to increase its net interest deductions in Australia by *increasing earnings in Australia. <u>The rules described in the paragraph above go against the policy underlying the new rules as it gives rise to a double benefit; the benefit of the income being NANE income and the benefit of a deduction for the interest expenses incurred to derive such NANE income</u>."*
>
> (paragraphs 1.118 and 1.119 to the draft Explanatory Memorandum to the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin Capitalisation Interest Limitation)

The underlined words suggest that the fundamentals of the new rules are sufficiently different to the old rules that an inappropriate double benefit would now exist – hence, the proposed repeal of s.25-90. On closer inspection, the logic behind this statement appears to be flawed.

Section 25-90 has been a fundamental part of Australia's tax policy settings since the current thin capitalisation provisions were introduced in 2001 (s.230-15(3) operates in the same way as s.25-90 for taxpayers that are subject to the TOFA provisions).

The background to s.25-90 can be summarised as follows:

- taxpayers that have a 10% or greater interest in a foreign company are able to treat dividends received from those foreign companies as NANE income;
- a taxpayer is generally not able to claim tax deductions for expenses (e.g., interest expenses) incurred in deriving either NANE income or exempt income;
- in 2001, when the previous thin capitalisation rules were introduced, a policy decision was made to deal with this deductibility issue (in relation to funding offshore subsidiaries) through the thin capitalisation rules (i.e., rather than by directly denying an entity deductions on the interest expense); and
- as such, s.25-90 was introduced alongside the thin capitalisation rules in 2001 - s.25-90 allowing taxpayers to claim deductions for interest costs incurred in deriving dividends from its qualifying offshore investments. As noted above, the reason for this was because a decision was made that the thin capitalisation rules would address the issue (through carving out the assets that derived the NANE income from a taxpayers thin capitalisation capacity – for instance, the exclusion of controlled foreign entity equity).

This logic was clearly reflected in the 2001 explanatory memorandum to the Act that introduced the thin capitalisation rules and s.25-90. Relevantly, the explanatory memorandum stated:

> *"Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. <u>These debt deductions</u>, provided they are otherwise allowable under the general deduction*

provisions, <u>will come within the scope of the thin capitalisation regime</u> when determining the amount to be allowed." (our emphasis added)

(paragraph 1.99 of the New Business Tax System (Thin Capitalisation) Bill 2001)

The principal benefit in dealing with the issue through the thin capitalisation provisions was that it meant that there was no requirement for the tracing of funds.

As such, a clear policy decision was made in 2001 to deal with this issue (i.e., expenses incurred in deriving certain types of NANE income) in a specific way – through the thin capitalisation provisions. There was no double benefit as an entity was, prima facie, entitled to a deduction but the underlying assets (the investment in an offshore subsidiary) would reduce the entity's thin capitalisation capacity.

The logic for dealing with it this way remains exactly the same under the new thin capitalisation rules as it was in 2001 (and has been for the last 20 years).

In this regard, although the new thin capitalisation provisions are based on an earnings test (rather than an assets or debt/equity test), the relevant income which is non-assessable (e.g., non-portfolio dividend income) does not form part of the earnings that are taken into account in determining an entity's thin capitalisation capacity.

It is also worth noting that almost all other countries that have adopted BEPS EBITDA based thin capitalisation provisions have not separately denied deductions for expenses incurred in deriving such non-assessable foreign income.

The repeal equally made no sense for banks that remained subject to the existing thin capitalisation provisions – for them, the thin capitalisation provisions had not changed (they remain subject to the ADI provisions) and the logic of the 2001 provisions remained unchanged.

There was a significant amount of lobbying on the proposal, from all parts of the taxpayer community that have overseas operations. The lobbying has, at least for the time being, been successful as the July 2023 revised provisions removed the s.25-90 repeal with the Government noting that:

"Stakeholder concerns regarding section 25-90 were considered by Government, with the proposed amendment deferred, reflected in its removal from the final legislation, to be considered via a separate process to this interest limitation measure."

(Government Impact Analysis – to the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023, page 98)

Hopefully, this proposal will not re-surface – or at least not for another 10 years or so (noting that a similar process took place in 2013 when there was last a push to remove s.25-90).

4 Scope of the new rules

The new provisions apply to 'general class investors' - which are all non-ADIs / non-financial entities that are either:

- an Australian entity with offshore operations (i.e., through an offshore subsidiary or branch);
- an Australian entity that is controlled by foreign residents; or
- a foreign entity with investments in Australia.

Aside from consideration of control type issues, the identification of who is subject to the thin capitalisation rules should be fairly straightforward.

One change that has been made that is causing interpretative problems is in relation to the narrowing of one limb of the 'financial entity' definition, namely the limb that applies to entities that are registered under the *Financial Sector (Collection of Data) Act 2001.* The new definition is as follows:

> *"(a) an entity that:*
>
> *(i) is a registered corporation under the Financial Sector (Collection of Data) Act 2001; and*
>
> *(ii) at the particular time, carries on a business of providing finance, but not predominantly for the purpose of providing finance directly or indirectly to, or on behalf of, the entity's associates; and*
>
> *(iii) in the income year in which the particular time occurs, derives all, or substantially all, of its profits from that business."*
>
> (paragraph (a) of the definition of financial entity in s.995-1(1))

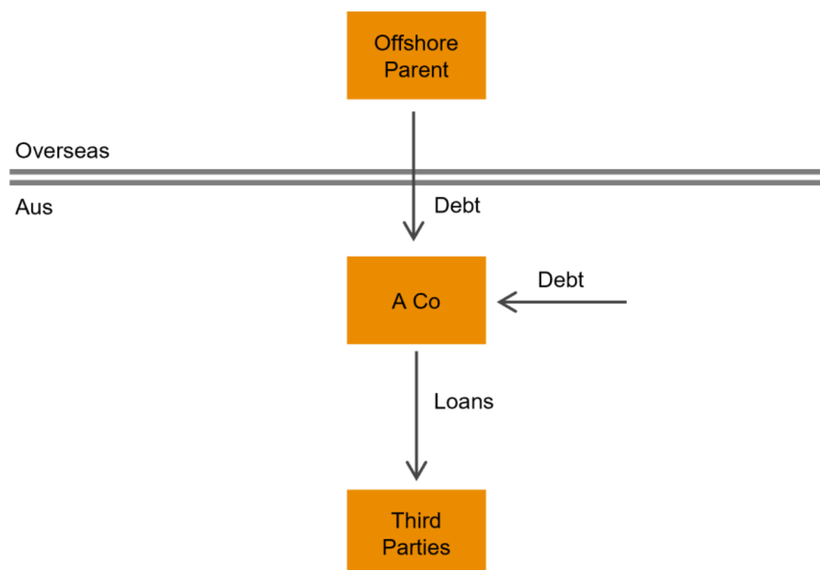
The provision was amended because there was a concern that groups were able to register an entity under this Act relatively easily and thereby obtain a concessional thin capitalisation treatment (financial entities generally benefit from 93% gearing capacity with some activities benefitting from 100% gearing capacity).

The changes that were made were to insert the additional requirements in sub-paragraphs (ii) and (iii).

The new tests have created uncertainty. Consider the following fact patterns:

- A Co provides finance to third parties.

Example 1

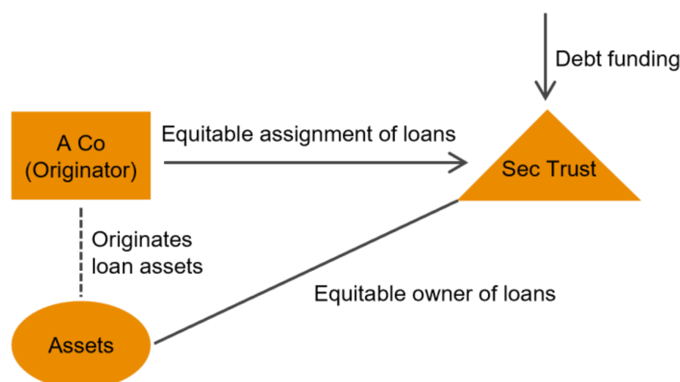


Some of A Co's funding comes from loans from its offshore parent. In this fact pattern, does the existence of the shareholder debt mean that the Australian group is providing finance 'directly or indirectly' on behalf of its parent (an associate)?

Unless the Australian group was acting as a mere conduit for its offshore parent (with little substantive activities), you would hope the answer to this would be no.

- A typical securitisation fact pattern where an entity in a group (A Co) originates receivables with third parties (e.g., provides loans to third parties) and then equitably transfers the receivables to a securitisation vehicle in the group (Securitisation Trust).

Example 2



In this fact pattern, A Co will typically be registered under the *Financial Sector (Collection of Data) Act 2001.*

Again, however, is A Co providing finance to the third parties on behalf of its associate (the Securitisation Trust)?

Part of the difficulty with this analysis is that, even if A Co and the Securitisation Trust are members of the same tax consolidated group, it seems clear that you have to apply this test having regard to the standalone activities of an entity. This follows from the fact that if an entity is treated as a financial entity then the entire tax consolidated group is then treated as a financial entity for thin capitalisation purposes.

5 The three alternative tests

A taxpayer has a choice in relation to apply either the:

- fixed ratio test;
- the group ratio test; or
- the third-party debt test.

The core fixed ratio test will apply unless an entity elects to apply either the group ratio test or the third-party debt test.

An election to apply either of these tests must be made on or before an entity lodges its income tax return.

Significantly, the election in respect of a particular year is generally irrevocable - the ATO has an ability to allow a taxpayer to revoke an election if the Commissioner considers it fair and reasonable to do so.

There are further restrictions in relation to the third-party debt tests which operates on a “one-in all-in” basis – i.e., if an entity elects to apply the third-party debt test then certain

related entities (certain associates that are 'obligors' in relation to the entity's debts under a modified test) must also apply the third-party debt test.

Australia adopted the OECD's recommended position in relation to 'net debt deductions' such that what is disallowed under the first two tests is an entity's 'net debt deductions' that exceed the fixed or group ratio.

The position is different under the third-party debt test where there is a disallowance of any debt deductions (i.e., gross debt deductions) that exceed the entity's 'third party earnings limit'.

6 The core rule – the fixed ratio EBIDTA test

6.1 Basic concepts

As summarised in the explanatory memorandum (**EM**) to the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023*, an entity's EBITDA is calculated as follows:

- Step 1: Work out the entity's taxable income or tax loss for the income year (disregarding the operation of the thin capitalisation rules and treat a tax loss as a negative amount). This excludes all franking credits and the net income from a trust or partnership, or dividends from a company, in which the taxpayer has a 10% or greater interest.
- Step 2: Add the entity's 'net debt deductions' for the income year.
- Step 3: Add the sum of the entity's decline in value and capital works deductions (i.e., Division 40 and 43 deductions) for the income year (plus certain forestry related deductions).
- Step 4: For certain trusts, add the 'trust excess tax EBIDTA amount' (i.e., excess EBIDTA from qualifying trusts in which the trust holds a 50% interest).
- Subject to Step 5, the result of Step 4 is the entity's tax EBITDA for the income year.
- Step 5: If the result of Step 3 is less than zero, treat it as being zero.

Some important points to note:

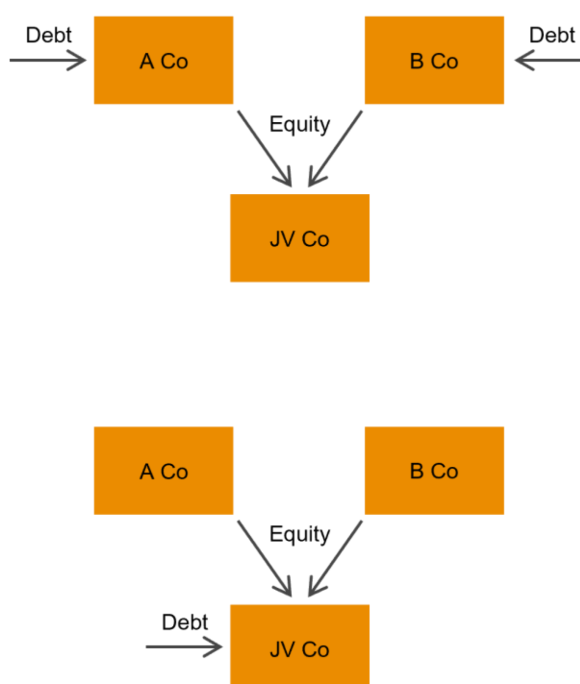
- Only net debt deductions are included – in determining net debt deductions interest payments, amounts that are economically equivalent and other related expenses are taken into account.
- The application of the CGT discount reduces the tax EBITDA capacity of a trust.
- Deductions under Division 40 and 43 (other than those that are immediately expensed) are added back.
- There were originally some fundamental flaws in the provisions in relation to the recognition of both dividends and distributions received from partnerships and trusts. Under the original draft of the provisions:
  - dividends (both franked and unfranked) were excluded in the calculation of EBITDA (the supposed logic being that the income represents profits that have already been taxed at the company level - and there should not be double counting of this income); and
  - amounts included in the tax EBITDA of a partnership or trust from the tax EBITDA of the partner or beneficiary were also excluded (the logic again being to prevent double recognition of the same income).

Both these points had the potential to cause significant problems and have been consistently raised in submissions.

Some of these issues have been partially addressed in the revised provisions – unfortunately, some have not.

- Consider the following simple corporate joint venture investment where the debt is either provided at the shareholder level or the JV Co level.

Example 3



In this example, if JV Co borrows then it should be entitled to deduct its interest expense (assuming that its underlying income / tax EBITDA is sufficient to permit deductibility).

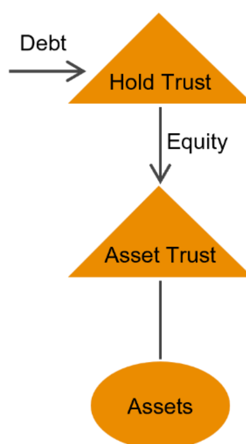
Conversely, if the debt is provided at the JV participants level then the interest will be non-deductible – as the receipt of dividends (whether franked or unfranked) will be excluded from A Co or B Co's tax EBITDA.

This outcome is surprising – and will make it necessary to have debt funding in the entity that will be deriving the underlying operating income (which may not be desirable for many legal and commercial reasons).

Unfortunately, this issue has not been addressed in the October 2023 revised provisions. Rather, the only dividend income that is included in the tax EBITDA of an entity is when the interest it holds in the underlying entity is a portfolio interest (i.e., of less than 10%). It is hoped that Treasury will reconsider this issue as part of finalising the provisions.

- The position for partnerships is similar to companies, in that, a partner in a partnership is only able to include its interest in the net income of an underlying partnership if it holds a portfolio interest in the partnership.
- The position for trusts has been improved in a situation where one resident unit trust / MIT holds a 50% or greater interest in another resident unit trust/MIT.

Example 4



In this fact pattern, under the original draft provisions Hold Trust would have been denied debt deductions because the income it derives (i.e., distributions from the Asset Trust) would not be included within its tax EBITDA.

Under the amended October 2023 draft provisions, the excess EBIDTA of a trust (here, Asset Trust) can be included in the tax EBITDA of another trust (Hold Trust) where both trusts are resident unit trusts / MITs and the higher trust in the structure has a direct control interest of 50% or more in the lower trust. However, a company unitholder cannot receive the benefit of the excess EBIDTA. Again, why this distinction exists is not clear.

Unfortunately, this solution for trusts is not uniform. As such, although the rules should work for trust interests of less than 10% (as distributions will generally be included in tax EBITDA) and interests of more than 50% (as excess capacity can be transferred up), entities that hold between 10% and 50% will not be able to benefit from either provision. This could have significant implications for joint ventures and consortium investments.

As can be seen in relation to anything other than a portfolio interest, dividends, distributions and inclusion of net income will generally not be included in the tax EBITDA of a shareholder, partner or unitholder (with the one exception being the ability to transfer excess trust EBITDA where there is a 50% or greater interest).

Although the problem of double counting is a legitimate one, it is hard to understand any reason why excess EBITDA can be transferred up from one qualifying trust to another (where there is a 50% interest) but similar rules do not exist for other entities like companies and partnerships.

It would be surprising if further submissions are not made on this point.

6.2 Debt deductions

Paragraph 1 of the definition of debt deduction in s.820-40 has been modified as follows:

(1) Debt deduction, of an entity and for an income year is a cost incurred 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 economically equivalent to interest; or

(ii) *the difference between the financial benefits received, or to be received, by the entity under a scheme giving rise to 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 a scheme giving rise to 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.*

Paragraph (2) is essentially unchanged. In summary, it provides costs under paragraph (1)(a) include discounts, amounts in substitution for interest, fees and charges in relation to a debt interest, the interest component of a hire-purchase, losses under repos and SLAs, etc.

Paragraph (3) sees a significant change as the exclusion in relation to losses incurred in hedging a financial risk in respect of the debt interest is removed. Paragraph (3) providing that:

> *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):*
>
> *(a) ;*
>
> *(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;*

A few observations on hedging arrangements:

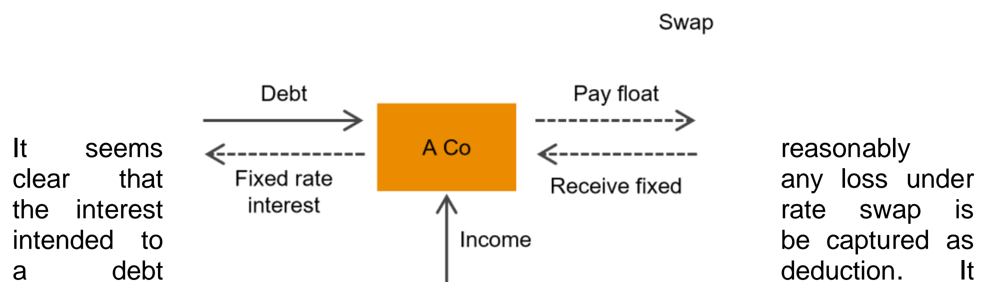
- The EM notes that:

  "It is intended that interest related costs under swaps, such as interest rate swaps, are included in the wider definition of debt deduction."

  (paragraph 2.59)

- Consider an example where a company issues a fixed rate loan and also enters into a fixed/floating interest rate swap to hedge its position.

Example 5



It seems reasonably clear that any loss under the interest rate swap is intended to be captured as a debt deduction. It

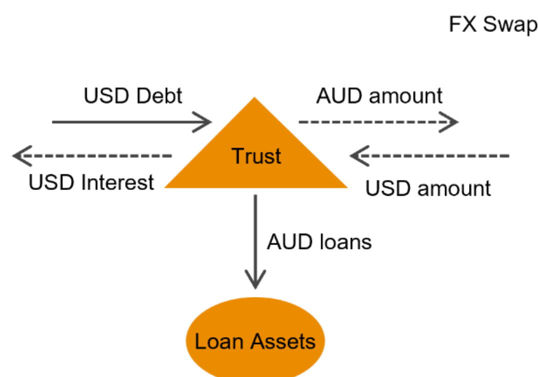
does not seem clear precisely how that cost is picked up under paragraph (1)(a) as:

- are the swap costs economically equivalent to interest?
- do the swap costs arise under a scheme giving rise to a debt interest?
- are the swap costs incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under a scheme giving rise to a debt interest?

The answer appears to be that the loss under the swap is part of the scheme giving rise to the debt interest and therefore covered under paragraph (a)(ii) or (iii).

- The position in relation to foreign exchange gains and losses is also not entirely clear. Although the OECD materials appears to envisage some FX gains and losses being captured, paragraph 3(b) makes it clear that FX losses should not be captured as debt deductions. Consider the following example:

Example 6



The Trust has AUD assets (loans) and USD borrowings. The Trust enters into an FX swap in order to hedge its foreign currency exposure. The existence of the USD debt and hedging arrangements should not impact the thin capitalisation position of the Trust.

In this regard, let's assume that the Day 1 exchange rate is 1:1 and the amount of a USD interest payment is 100:

- If there is an FX loss of AUD10 on the USD interest payment then there will be a AUD10 FX gain on the swap. The debt deduction should be AUD100 as the 10 FX loss should be excluded under paragraph 3(b).
- If there is an FX gain of AUD10 on the USD interest payment (therefore AUD equivalent payment of 90) then there will be a AUD10 loss on the swap. The debt deduction should be AUD100 being the AUD90 interest payment and the AUD10 loss under the swap (which should be a hedging instrument similar to the interest rate swap considered above).

6.3 Carry forward of excess debt deductions

Any excess deductions (referred to as 'FRT disallowed amounts') that are denied under the fixed ratio test will be available to be carried forward for up to 15 years.

The ability to carry forward is subject to a number of restrictions including:

- The entity is still applying the fixed ratio test (i.e., it has not elected to apply one of the other tests).
- In relation to a company, it satisfies a modified COT or BCT.
- In relation to a trust, it satisfies a modified version of the trust loss rules
- If an entity joins a tax consolidated group then the entity can transfer any such fixed ratio disallowed amount (i.e., the disallowed interest deductions that it has carried forward) subject to the satisfaction of various conditions.

A few observations:

- Australia chose not to allow the carry forward of excess interest capacity (i.e., where EBITDA in the year exceeds interest deductions in a year).
- Australia did not implement any general exemptions for public / private projects where there is a large initial capital investment, tax losses in the early years before the project is developed and income generated in later years. Rather, taxpayers in such projects will have to rely on the ability to recognise excess deductions on a go forward basis (noting also that if they switch to the third party debt test, which they may, the FRT disallowed amounts will be lost).
- How much value is going to be placed on these losses is uncertain – for instance, some investors will want to exit large projects after a period of time, which will impact the ability to carry forward the excess deductions.

7 Third Party Debt test

Until the 'debt creation rules' were introduced the third-party debt test provisions were regarded as the most contentious part of the provisions.

As a starting point, it is worth noting that the third-party debt test does not flow from the OECD Report or recommendations. It is something that Australia has introduced in recognition of the fact that Australia has had an arm's length debt test for many years. Many other countries also have an arm's length debt test – which frequently is not limited to third party debt.

In short, although there have been changes to the draft provisions (following submissions) it remains unlikely that the third-party debt test will be broadly used other than for some purely Australian assets – this arises from the fact that the provisions remain narrow.

The discussion in the EM on the third-party debt test started positively for taxpayers as it provided:

> *"The test is intended to be a simpler and more streamlined test to apply and administer than the former arm's length debt test, which operates based on valuation metrics and the 'hypothesised entity comparison'".*
>
> (paragraph 2.91)

This aspiration was entirely logical – the previous test was complicated and required a hypothesis in relation to what a borrower could borrow and a lender would provide (taking account of various factors and required assumptions). The provisions were difficult to apply and required a significant amount of analysis and work. The principle behind the new provisions is much simpler – i.e., if an independent third-party lender is prepared to provide debt than that should provide evidence that the debt is genuine third-party debt.

Unfortunately, that was the end of the good news for taxpayers. The EM then went on to provide:

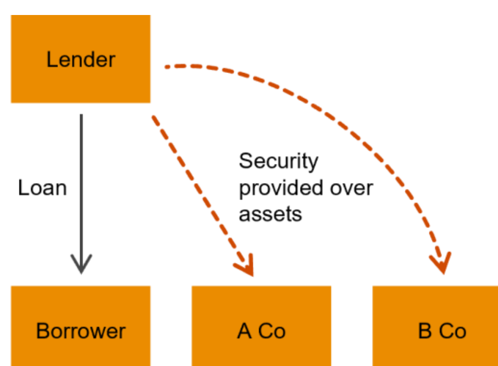
“The third-party debt test is intended to be narrow, to accommodate only genuine commercial arrangements relating to Australian business operations.”

(paragraph 2.92)

Although the revised draft of the provisions is wider than the original draft, the provisions remain narrow – the main restrictions being:

- If an entity makes an election then the election will also automatically apply to various associated entities. In undertaking this test, some new ‘associate’ concepts are created (this is a theme that will come up again later in this paper). In summary:
    - The first step is to identify the ‘obligor group’ which is the entity that issues a debt interest (the borrower) and the entities which the lender has recourse against to the assets of those entities (see s.820-49).
    - Consider the following fact pattern:

Example 7



In this example, A Co and B Co are both members of an ‘obligor group’ with the Borrower as the Lender has security over their assets (or some of their assets) in relation to the loan provided to the Borrower.

    - If any member of the obligor group is an ‘associate entity’ of the Borrower then that entity will be treated as having also elected to apply the third-party debt test if the Borrower makes the election to apply the third-party debt test.
    - In determining whether an entity is an ‘associate entity’ the current test in s.820-905 is applied with one important amendment – that is the bar is significantly lowered by changing the 50% test that currently exists to a 20% control interest test.
- The lender can only have recourse to (i) Australian assets that are held by the borrower, (ii) Australian assets held by an Australian entity that is a member of the ‘obligor group’ (see comments above) and (iii) membership interests in the Australian borrower (unless the borrower has direct or indirect interests in non-Australian assets).
- The lender cannot receive any guarantee, security or other form of credit support (e.g., a parental guarantee, cross guarantee or the provision of a letter of credit). There are certain limited exceptions to this in relation to credit support where the right relates wholly to the creation or development of Australian real property (or moveable property situated on Australian real property) in Australia – this

exception is intended to be narrow and to relate to greenfield or development phase property assets in Australia.

- The borrower uses all (or substantially all) of the funds raised to fund its Australian activities (and not any offshore branch activities, associate entity debt, controlled foreign entity debt or controlled foreign entity equity).

These restrictions are likely to mean that the provisions are unworkable for many entities.

There are logical reasons why certain things are prohibited – for instance, an Australian entity cannot over gear itself and obtain excessive debt deductions as a result of credit support provided by its offshore parent. This would effectively allow excessive debt to be pushed down to Australia.

Why such a guarantee or credit support provided by an Australian entity (which has Australian assets) is not able to be provided does not seem as clear.

Also of significance is the fact that the provisions will impact existing borrowing arrangements. Accordingly, even if a taxpayer was able to obtain new third-party financing that satisfied these tests it is extremely unlikely that any existing debt would also satisfy these tests – as the taxpayer would not have considered these tests when it entered into that borrowing.

The third-party debt test does also contain conduit financing provisions which, subject to the satisfaction of certain conditions, allow an entity to borrow funds from the market (from third parties) and on-lend the funds to associated entities.

8 Debt Creation Rules

8.1 Background and opening comments

When the revised draft provisions were issued in June 2023, the debt creation rules were inserted. There was no forewarning of this – the provisions took everyone by surprise.

When you read the EM, it appears that the rules are intended to be narrow anti-avoidance provisions directed at certain related party financing – the EM states that:

> *"Excessive debt deductions pose a significant risk to Australia's domestic tax base.*
>
> *The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.*
>
> *New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent they are incurred in relation to debt creation schemes that <u>lack genuine commercial justification</u>.*
>
> *Subdivision 820-EAA represents a modified version of the debt creation rules in former Division 16G of the ITAA 1936. Subdivision 820-EAA is consistent with Chapter 9 of the OECD's BEPS Action 4 Report (specifically paragraphs 173 and 174 of that report) which recognises the need for supplementary rules to prevent debt deduction creation.*
>
> *………..*
>
> *Subdivision 820-EAA disallows debt deductions in two cases. These cases represent integral parts of schemes where <u>artificial interest-bearing debt</u> is created within a multinational group. Over time, this interest-bearing debt*

effectively allows for profits to be shifted out of Australia in the form of tax-deductible interest payments."

(paragraphs 2.144 to 2.149)

The draft provisions (even as modified by the October 2023 amendments) appear to be significantly wider than this description – there is certainly no concept of either a 'scheme' or 'artificial' arrangements in the core draft provisions.

Before considering the scope of the draft provisions, I would make the following observations:

- The comments appear to start from the position that all related party debt is problematic and an intrinsic threat or 'significant risk' to the tax system.
- It is difficult to see why this risk is not addressed by the combination of the thin capitalisation rules generally and the transfer pricing rules – i.e., the thin capitalisation rules impose limits on the amount of debt / deductible interest that a taxpayer is allowed (generally doing this by reference to all debt, whether third party or related party) and the transfer pricing rules impose arm's length conditions on related party debt.
- The comments in the EM provide that the rules are directed at 'artificial' arrangements which 'lack genuine commercial justification'. These type of concepts are usually consistent with anti-avoidance provisions which are directed at one or more fact patterns that the legislature feels need to be addressed. No such examples are provided in the EM. Indeed, this is perhaps the fundamental problem with the provisions – there is no indication of precisely what they are directed at other than related party debt which funds certain activities. It is not clear why such funding arrangements are 'artificial'.
- The provisions are stated to be a modified version of the debt creation rules in the former Division 16G (which was repealed in 2001). Again, the linkage between the two is not clear. The previous Division 16G applied when debt was created in connection with certain cross border corporate restructures. The purpose of the rules was to ensure that an Australian entity did not obtain increased Australian tax deductions as a result of restructures that had a foreign element (for instance, a significant foreign shareholder).

  In his 1998 article, Professor Vann summarised the operation of the then draft Division 16G as follows:

  "The draft bill applies where, apart from the new rules and the thin capitalisation rules, an amount of interest would be allowable as a deduction from the assessable income of a company taxpayer if the interest is in respect of an amount owing in connection with the acquisition of an asset by the taxpayer. If these conditions apply, then three specific situations are delineated where interest deductions will be denied. Firstly, where the seller of the asset was a foreign controller of the taxpayer immediately after the acquisition.. Secondly, where the taxpayer was a foreign controller of the seller of the asset immediately after the acquisition. Thirdly, where a person was a foreign controller of the seller immediately before the acquisition and a foreign controller of the buyer immediately after the acquisition.

  ……..

  Where the conditions referred to above are fulfilled, the interest deduction that would otherwise be available on the monies borrowed to acquire the asset is reduced by an amount depending on the "asset ownership factor" and the "capital entitlement factor". For example, if a foreign controller owns 50% of an Australian company which purchases an asset from the foreign controller in exchange for debt, the interest deduction will be denied as to half.'

The debt-creation rules are not limited to the situation where debt is being used to fund a cross-border corporate restructure. As such, the linkage to Division 16G is not entirely clear.

Also of note is the fact that Division 16G was repealed in 2001 as part of the package that introduced the current suite of thin capitalisation provisions. Although not explicitly stated in the 2001 explanatory memorandum, a reasonable conclusion may be that Division 16G was no longer required post 2001 because of the introduction of a set of comprehensive thin capitalisation rules.

- Reference is made to the new debt creation rules being consistent with the OECD recommendations. On this, the OECD Report does note that notwithstanding the general thin capitalisation rules certain targeted rules may still be required. In this regard, the OECD Report states that:

"……..

Therefore, it is recommended that countries consider introducing rules to address the risk 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.*
- *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 to a related party, which is subject to no or low taxation on the corresponding interest income.*

Rules to address the risks above should ideally be applicable to all entities irrespective of whether they are also subject to the fixed ratio rule and group ratio rule. However, these rules are particularly important when an entity is not subject to a fixed ratio rule."

(Paragraphs 173 and 174 of the OECD Report)

The concerns that are reflected in the OECD Report are specific fact patterns which have an artificial or structured feel. The proposed Australian debt-creation rules are wider – going beyond what was envisaged in the OECD Report.

I suspect that the debt creation rules are partly driven by concerns with some fact patterns over the last few years – this principle appears to be reflected in the testimony of the ATO before the Senate Economics Committee. In this regard, the Committee reports states:

"Elaborating on the need for the rules to address artificial debt creation and the views of the tax advisor community, the ATO told the committee:

> *"… we are aware of views 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 we can't otherwise address without these rules, so there's evidence of it in the past."*

(paragraph 2.105 of the Senator Economics Committee Report)

I don't know what debt creation schemes the ATO is referring to, albeit it is probably reasonable to suspect that some of them relate to debt funding to fund the acquisition of an asset from a related party.

I fully recognise the need for the ATO and Treasury to respond to activities and amend the law to stop activities which they consider to be egregious. This is typically what anti-avoidance provisions do.

The challenge with the debt creation rules (especially the second debt creation rule) is that they appear to go well beyond attacking 'artificial' debt creation schemes. Indeed, they appear to have the potential to make most forms of shareholder debt problematic – for the reasons discussed in section 8.3 below.

If the aim of the provisions is to prevent almost all forms of shareholder debt then that principle should be made clear by Treasury. If conversely, the provisions are aimed at certain specific activities (i.e., artificial debt creation schemes) then the provisions should be narrowed to reflect that principle and Treasury should provide clear guidance / examples in relation to the type of transactions that the provisions are designed to capture.

There are also some important questions of grandfathering in relation to the debt creation rules – which are discussed in section 9 below.

Before considering the two specific debt creation rules in further detail, two general points are worth noting:

- the provisions do not apply to ADIs or securitisation vehicles (including vehicles to which the securitisation exemption in s.820-39 applies). This was a logical and welcome amendment to the rules. Hopefully, the exceptions will also be extended to 'financial entities' under the thin capitalisation rules; and
- the debt creation rules apply in priority to the thin capitalisation rules – if a debt deduction is denied under the debt creation rules then the debt deduction is disregarded when applying the general thin capitalisation rules.

8.2 Debt Creation Rule 1 – acquisition of a CGT asset or legal / equitable obligation

(a) Scope

The first debt creation rule is directed at the situation where related party debt is used to fund the acquisition of an asset from a related party.

Significantly, the provision has been narrowed from its original June 2023 draft – as originally it applied to any debt that funded the acquisition of an asset from a related party. However, there is still no exclusion for amounts borrowed from third parties indirectly through a (non-consolidated) finance company or trust. In this circumstance:

- the exclusion for borrowings to acquire debt interests issued by associates would protect the finance company / trust; but
- the ultimate borrower would be denied debt deductions if it used the funds borrowed to acquire an asset from an associate.

The first debt creation rule is set out in s.820-423A(2) and applies where the following conditions are satisfied:

> *"(a) an entity (the **acquirer**) *acquires a *CGT asset (other than a CGT asset covered by section 820-423AA), or a legal or equitable obligation, either directly, or indirectly through one or more interposed entities, from one or more other entities (each of which is a **disposer**);*

(b) one or more of the disposers (each of which is an ***associate disposer****) is an *associate pair of the acquirer;*

(c) the entity mentioned [that has the debt deductions] (the ***relevant entity****) is:*

(i) the acquirer; or

*(ii) an *associate pair of the acquirer; or*

(iii) an associate pair of an associate disposer;

*(d) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to any of the following:*

(i) the acquisition mentioned in paragraph (a) of this subsection;

(ii) the acquirer's holding of the CGT asset, or legal or equitable obligation.

(e) the relevant entity's debt deduction mentioned in subsection (1) is referable to an amount paid or payable, either directly or indirectly, to any of the following:

(i) an associate pair of the relevant entity;

(ii) an associate pair of the acquirer;

(iii) an associate pair of an associate disposer."

There is a further provision which ensures the provision applies to indirect acquisitions.

(b) Associate Pair

As can be seen from the provision (set out above), we have another new 'associate definition' being that of an 'associate pair'.

An associate pair is essentially two entities where at least one is an associate of the other (noting that under s.318 it is, in theory, possible for A to be an associate of B, but not vice versa) (see the new 'associate pair' definition inserted in s.995-1(1)).

One potentially important change that is made to the associate definition for the purposes of determining whether an entity is an associate pair of another entity is the amendment to the associate test for unit trusts (see the proposed new s.820-423E). In this regard, the amendment treats the unit trust as a company such that:

- the mere fact that an entity is a direct or indirect minority beneficiary of a trust (that is not a public unit trust) does not make the entity an associate pair of the trust; and
- the sufficient influence test in s.318 is relevant in terms of determining whether the trust is an associate of another person or the other person is an associate of the trust.

The new definition provides one limited safeguard such that small minority investors and secured creditors protecting their rights as lenders should not be taken to possess sufficient influence.

This change to the associate definition for unit trusts is a potentially important one. Although it only applies in determining an associate pair, it will be interesting to see whether this approach is followed more broadly going forward across other parts of the Act.

(c) Exceptions

The October 2023 draft also includes a number of exceptions from the application of the first debt creation rule such that the rule will not apply in relation to:

- New membership interests in an Australian entity or foreign company. As such, the issue of new shares by a company will not be caught.

- Acquisitions of new depreciating assets which are expected to be used within 12 months for a taxable purpose.
- Debt interests issued by associates. This is a welcome change and is intended to ensure that related party lending by an Australian entity is not caught by the rules.

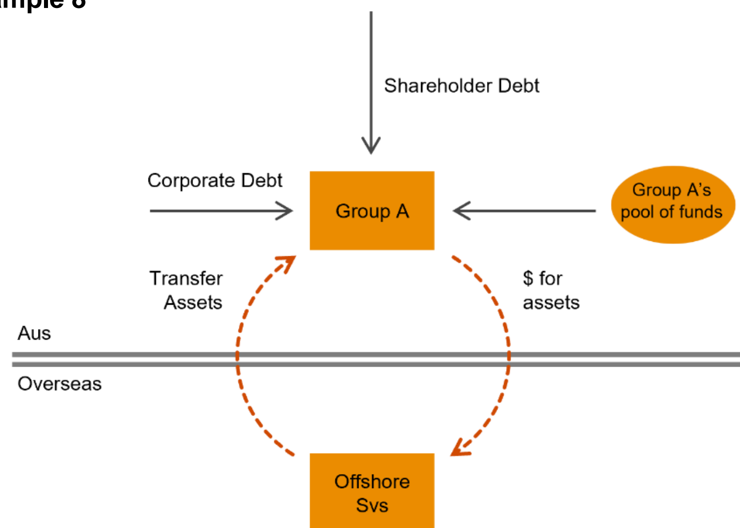
(d) Comments

This first debt creation rule has been narrowed by the October 2023 change which requires the funding to be related party funding (i.e., funding from an associate) – the previous draft applied to any debt funding that funded the acquisition of an asset from an associate.

At a practical level consideration will need to be given to this rule whenever it is envisaged that an asset (or a legal or equitable obligation) may be acquired from an associate.

Consider the following example:

Example 8



Group A is closing down an offshore subsidiary. As part of this, it is moving some of the assets back to Australia (i.e., Group A is buying the assets back from Offshore Sub).

Group A can use either (i) borrowings under its general corporate facility or (ii) funds from its general pool of funds to buy the assets. Group A has a shareholder loan from its parent – which have been used in the business and have contributed to the general pool of funds.

In this fact pattern:

- Does Group A need to positively demonstrate that it can trace the funds used to buy the assets form its non-related party borrowings (for instance, to specific third-party borrowings)?
- What happens if Group A uses funds from its general pool of funds – is this problematic because it has related party debt (e.g., shareholder debt) in existence?
- Is the position different if the shareholder debt was provided 1 week ago, 3 months ago or 3 years ago?

The answers to these questions will turn on the scope of the requirement in paragraph (d) that the debt deduction (on the related party debt) is 'wholly or partly' in relation to the acquisition or the holding of the asset.

Consideration of this is going to involve issues in relation to tracing of funds. As no guidance has been provided in the EM, taxpayers will be left trying to form views on this and / or waiting for ATO guidance.

The upshot is likely to be considerable uncertainty.

It is also worth querying how this first debt creation rule interacts with the general tax policy settings in Australia. Over the last decade we have seen ATO interpretations and changes in law which have encouraged taxpayers to move assets back to Australia in various fact patterns – consider for instance, the views on CFCs and AFI subsidiaries and the introduction of the diverted profit tax rules. If there is a policy setting effectively requiring taxpayers to hold assets in Australia (unless there is real substance overseas) then it seems counter-intuitive to have an anti-avoidance provision which prevents such assets being repatriated to Australia if they are funded with related party debt.

8.3 Debt Creation Rule 2 – acquisition of a CGT asset or legal/equitable obligation

(a) Scope

The second debt creation rule is directed at the situation where related party debt is used to fund the payment of amounts or distributions to an associate.

The second debt creation rule is set out in s.820-423A(5) and applies where the following conditions are satisfied:

"(a) an entity (the ***payer****) obtains proceeds from entering into or having a *financial arrangement with another entity;*

(b) the payer uses some or all of the proceeds to:

(i) fund; or

(ii) facilitate the funding of; or

(iii) increase the ability of any entity (including the payer) to make;

one or more payments or distributions (within the meaning of section 26BC of the Income Tax Assessment Act 1936), other than a payment or distribution covered by subsection (5A) or (5B) of this section, that it makes to one or more other entities (each of which is a ***recipient****);*

(c) one or more of the recipients (each of which is an ***associate recipient****) is an associate pair of the payer;*

(d) the entity mentioned in subsection (1) (the ***relevant entity****) is any of the following:*

(i) the payer;

(ii) an associate pair of the payer;

(iii) an associate pair of an associate recipient;

*(e) the relevant entity's *debt deduction mentioned in subsection (1) is, wholly or partly, in relation to the financial arrangement mentioned in paragraph (a) of this subsection;*

(f) the relevant entity's debt deduction is referable to an amount paid or payable, either directly or indirectly, to any of the following:

(i) an associate pair of the relevant entity;
(ii) an associate pair of the payer;
(iii) an associate pair of an associate recipient."

The two exceptions that are covered in (5A) and (5B) are intended to cover on-lending to an Australian associate and the repayment of principal under a debt interest. These exceptions are intended to allow groups that centralise treasury activities to continue to do so – for instance, by on-lending and also by refinancing related party loans as they mature with new related party loans. There are some problems with how the provisions have been drafted that will hopefully be picked up in the final provisions.

The key condition in the test is that contained in paragraph (b) above which asks whether an entity uses the related party debt to fund, facilitate the funding or increase the ability of an entity to make a payment or distribution to an associate.

There has been a significant change to this test in the October 2023 draft of the provisions. Relevantly, in the original July 2023 draft there was a requirement that the proceeds of issuing the debt interest were used 'predominantly' to fund the relevant payment or distribution. This 'predominantly' requirement has been omitted from the October 2023 draft. As such, it appears that if any part of the proceeds of the financial arrangement are used to fund a payment or distribution to an associate then the provision will be enlivened.

It should be noted that the debt deduction that is denied is only the debt deduction 'to the extent' incurred in relation to the proceeds referred to in paragraph (b) above (see s.820-423B(2)). Although this is logical and helpful it still means that a taxpayer must consider whether the second debt creation rule applies even if only a small part of the funds have been used in an unpermitted manner.

These concepts of funding are subject to further clarification in sections 832-423A(6) and (7) which provide that:

- payments / distributions may be made directly or indirectly through one or more interposed entities;
- payments / distributions may be made at or after the time the entity enters into the financial arrangement; and
- in determining whether a payment / distribution is made directly or indirectly it is sufficient if payments exist between each interposed entity and:

  "it is not necessary to demonstrate that each payment in a series of payments funds the next payment or is made after the previous payment."

  (s.832-423A(7)(b))

If there was any doubt about how important tracing of funds potentially is to the second debt creation test, these provisions make it clear.

These further principles are important as they extend the reach of the provision. For instance:

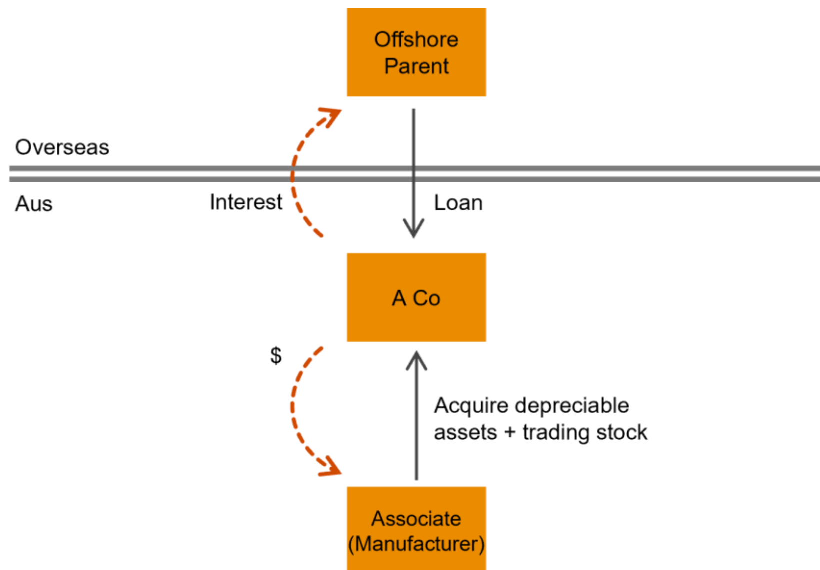
- How long will a taxpayer have to consider whether related party debt has been used to fund another payment – 1 month, 3 months, 1 year or longer (bullet point 2 above)?
- What is the extent of the tracing required – it is clear that the provision extends beyond mere simple on-payments – however, what is the relevant nexus required (bullet point 3 above)?

(b) Comments

This second debt creation test has the potential to raise issues whenever an entity has related party debt – the classic example being a shareholder loan from a parent entity.

Let us start with a simple fact pattern where an entity borrows funds from its parent to acquire either a new depreciable asset or trading stock from an associate.

Example 9

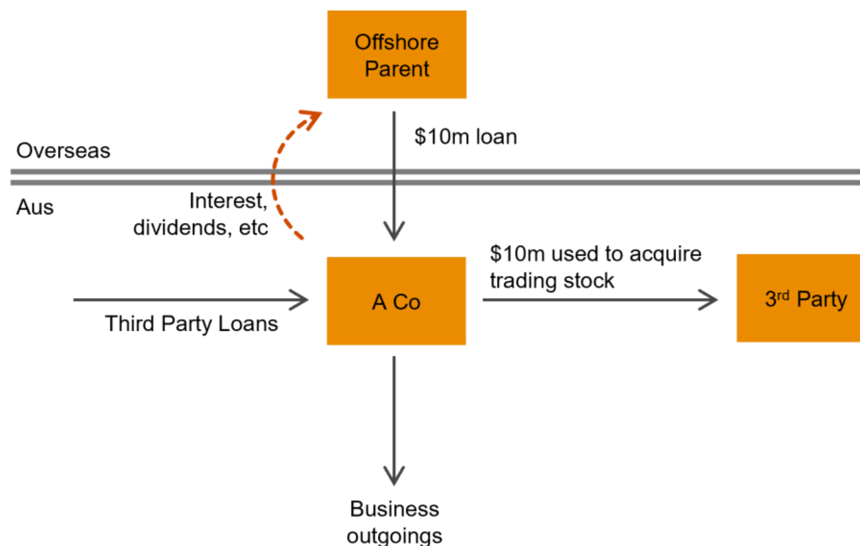


In this example, A Co will be denied deductions as it has borrowed money from an associate and used those funds to make payments to an associate (to acquire the assets).

Note that the second debt creation rule appears to apply even though the acquisition of new depreciable assets is specifically carved out of the first debt creation rule.

Consider another example where the shareholder debt is specifically used (traced) for a 'good' purpose – for instance, the acquisition of trading stock form a third party.

Example 10



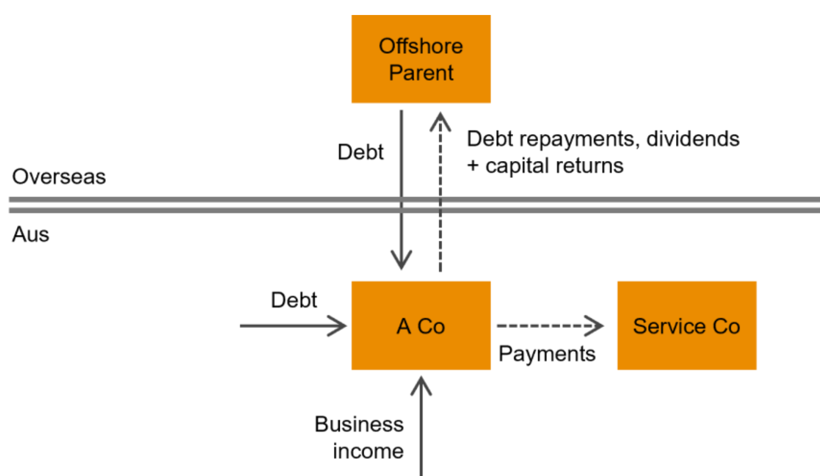
In this example, A Co has used the $10m shareholder loan to acquire specific assets (trading stock). As such, prima facie, the funds have not been used to fund or facilitate the funding of a payment to an associate.

However, the provision does not simply look at what payments have funded other payments but also captures the situation where the proceeds of the financial arrangement 'increase the ability of any entity (including the payer)' to make the relevant payment or distribution to an associate.

Is the test infringed in this fact pattern as the shareholder loan of $10m will increase A Co's ability to make other payments, including payments to associates – as other 'good' funds will not have been used to acquire the trading stock this must necessarily mean that A Co has more funds available generally, including to make interest and principal payments on the shareholder loan and dividend payments.

Consider the more complicated fact pattern where A Co has a pool of funds:

Example 11



A Co has obtained loan funding from its parent – normal shareholder debt. Those funds are used in A Co's general business activities. A Co also has third party debt and funds from its ongoing business activities.

On an ongoing basis, A Co will make payments to its associates – e.g., fees paid to Service Co, interest and principal repayments on its shareholder loan, dividends / capital returns to its shareholder, etc.

As funds will typically be fungible, it will be difficult for A Co to demonstrate that some of the funds from its shareholder loan haven't been used to make payments to its associates (whether directly or indirectly).

This type of fact pattern involving a corporate group with shareholder debt is extremely common. If such funds simply go into a pool of funds (along with business income, third party debt, etc) there is going to be a significant concern in relation to whether the group can ever get comfortable that the second debt creation rule doesn't apply. This is particularly the case as the test applies when the loan has increased the ability of any entity (including the payer) to make the relevant payments or distributions (see comments above).

It is unfortunate that there is no guidance on these issues in the EM – either on a principle basis or by reference to examples. The type of issues that should be considered and guidance provided include:

- To what extent is tracing of funds is permitted – for instance, if shareholder debt is specifically used to fund third party activities (and the money is traced in this way), is this ok?
- Following on from the first bullet point, if shareholder debt is used to fund third party activities then guidance should be provided that confirms that this does not infringe the test in relation to effectively increasing the ability of an entity to make other payments to its associates.
- If tracing is permitted, do the funds have to go into separate bank accounts – for instance, shareholder loan funds are quarantined in a specific bank account and only used for permitted activities?
- What approach will be taken in relation to pool of funds – which include equity, related party loan funding, third party loan funding, etc?
- Is the mere existence of shareholder loan funds in a pool of funds problematic – does that mean that some part of any payment to an associate will have been directly or indirectly funded by such funds?
- Will it make any difference when the shareholder loan was provided – for instance, recently or years ago – are timing issues relevant to tracing and pool of funds issues.

The fact that we are having to consider these type of issues is extremely disappointing in the context of arrangements that are directed at 'artificial' or 'contrived' arrangements. Although there may be issues with some related party debt this should not take away from the fact that shareholder / parental debt is an entirely normal and common form of financing. The scope of the second debt creation rule appears to potentially make vanilla shareholder loans problematic.

I would also note that the general trend of tax laws has been to move away from provisions or tests which require tracing of funds. In this regard, Governments and tax administrators have generally recognised the difficulties associated with pools of funds and the fungibility of money. By way of example, I understand that it was largely for this reason that s.25-90 was introduced in 2001. It is going to create both uncertainty and practical difficulties if taxpayers have to start considering issues of tracing again (similar issues have also arisen in relation to the changes directed at equity funded distributions).

Unless the aim of the second debt creation rule is to prevent or heavily restrict related party debt per se, I would urge Treasury to reconsider its scope having regard to the principle that it is directed at artificial or contrived arrangements. If it is not narrowed then taxpayers will face significant uncertainty and risks in relation to all shareholder debt.

9 Timing, grandfathering and transitional arrangements

One of the most contentious aspects of the new rules is in relation to the general lack of transitional arrangements and grandfathering.

There are some interesting comments in the OECD Report about transitional rules. In particular, the Report notes that:

> *"The best practice approach set out in the report should address base erosion and profit shifting involving interest. However, it is recognised that any rule to limit tax deductions for an entity's interest expense could involve a significant cost for some entities. Therefore, it is expected that a country introducing a fixed ratio rule and group ratio rule would give entities reasonable time to restructure existing arrangements before the rules come into effect.*
>
> *A country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely. In this case it is recommended that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced. Interest on any loans entered into after the announcement of the new rules should not benefit from any transitional provisions."*
>
> (my emphasis added)
>
> (paragraphs 194 and 195 of the OECD Report)

In other words, the OECD contemplated both some grandfathering of existing loans and a start time which allowed entities sufficient time to restructure prior to the start date.

Australia has not adopted either of these alternatives. Rather, subject to the start date for the debt creation rules, Australia has:

- Introduced the provisions with a start date of 1 July 2023 (i.e., income years commencing on or after 1 July 2023) even though the provisions are still being considered and amended (and are still in draft form).
- Not adopted any transitional arrangements.
- Not provided any grandfathering of existing arrangements.

Subject to one point, the lack of any grandfathering arrangements is understandable as it is difficult to see how different thin capitalisation provisions could apply in tandem (it is not like pre and post TOFA financial arrangements which can be tracked on an individual basis).

In my view, the one clear exception to this should have been in relation to the debt creation rules. They are supposed to be targeted anti-avoidance rules. Such rules should not be applied on a semi-retrospective basis (i.e., to existing arrangements that were entered into before the announcement of the rules). In this regard, taxpayers had no knowledge of the rules when they entered into historic arrangements and should not be penalised in relation to those arrangements as a result of a change in law.

In this regard, some taxpayers will have existing funding arrangements in place which may be caught under the debt creation rules. I say 'may' as identification of such arrangements is likely to be almost impossible – i.e.. having regard to pool of funds and the fungibility of money how are taxpayers going to be able to identify what debt funding is in existence that may be caught by the rules (as taxpayers generally will not have traced funds)? As such, it would have been logical to simply grandfather existing funding arrangements from the scope of the debt creation rules.

Following extensive lobbying, the start date for the debt creation rules has been amended so that for debt deductions that relate to financial arrangements entered into before 22 June 2023 (the date that taxpayers became aware of the debt creation rules), the debt creation rules will apply to income years commencing on or after 1 July 2024. This is not a grandfathering of arrangements but a deferred start date for such arrangements.

Significantly, the debt creation rules contain a specific restructuring anti-avoidance provision – which provides in s.820-423D that if the Commissioner is satisfied that:

> *"…. it is reasonable to conclude that one or more entities (each of which is a* ***participant****) entered into or carried out a *scheme for the principal purpose of, or for more than one principal purpose that included the purpose of, achieving any of the following results:*
>
> *(i) [the first debt deduction rule] does not apply in relation to a *debt deduction;*
>
> *(ii) [the second debt deduction rule] does not apply in relation to a debt deduction;*
>
> *(whether or not the debt deduction is a debt deduction of any of the participants and whether or not any of them carried out the scheme or any part of the scheme); and*
>
> *(b) the scheme has achieved, or apart from this section would achieve, that purpose.*

the Commissioner may make a determination that the *"Act has, and is taken always to have had, effect as if"* the debt deduction rules apply to the debt deduction.

This rule gives the Commissioner the ability to disallow debt deductions on a new third-party loan if that third party loan has been entered into in order to enable a taxpayer to avoid the application of the debt creation rules. By its very nature this involves a restructure of a loan that otherwise infringes the debt creation rules.

The existence of the restructure anti-avoidance provision is surprising. The BEPS related changes to Australia's tax laws have generally proceeded on the basis that the provisions are designed to encourage taxpayers to change their behaviour and accordingly to restructure out of problematic arrangements – this principle was seen with the hybrid mismatch rules. Subject to one point (considered below) this principle has not been applied to the debt creation rules.

If any 'bad' related-party debt exists after 1 July 2024 then it is likely to be difficult (as a result of this restructure anti-avoidance rule) to restructure that debt into 'good' third party debt. However, where are the boundaries?

Consider, the following fact patterns all undertaken post 1 July 2024:

- 'Bad' related-party debt is repaid at the end of its term and the company enters into new third-party debt. Hopefully it is clear that this is not problematic – as there should be no scheme to avoid the application of the debt creation rules (the original loan has simply been repaid in accordance with its terms and new third-party debt entered into).
- 'Bad' related party debt is repaid early and replaced with 'good' third party-debt – this appears to be potentially problematic (albeit why this is problematic from a policy perspective is unclear).
- 'Bad' related party debt is repaid from the company's general pool of funds and some months later the company borrows 'good' debt from a third party – in a different amount from the 'bad' related party debt. It would be hoped/expected that this would not be problematic.

The EM provides no substantive guidance in relation to the restructure rule, simply stating that:

> *"An anti-avoidance provision ensures the debt deduction creation rules cannot be readily avoided. Broadly, if the Commissioner is satisfied that a principal purpose of a scheme was to avoid the application of the rules in relation to a*

> *debt deduction, then the Commissioner may determine that the rules apply to that debt deduction."*
>
> (paragraph 2.154)

Treasury should provide clear guidance on these type of vanilla fact patters in the EM.

The further question that exists is in relation to restructuring related party debt prior to 1 July 2024.

Let's assume that a company is concerned that a shareholder loan that it took out a number of years ago potentially infringes one of the debt creation rules. Is it ok for the taxpayer to restructure that debt prior to 1 July 2024?

Logically the answer to this should be yes – the debt creation rules do not apply until 1 July 2024 and accordingly any restructure prior to this date should not be caught. In my view, this is the correct interpretation of the timing / start date provisions which provide that:

> *"820-50 Application of Subdivision 820-EAA of the Income Tax Assessment Act 1997*
>
> *(1) Subject to this section, Subdivision 820-EAA of the Income Tax Assessment Act 1997 applies in relation to an income year that begins on or after 1 July 2023.*
>
> *(2) Subject to subsection (3), Subdivision 820-EAA does not apply to a debt deduction that relates to a financial arrangement entered into before 22 June 2023.*
>
> *(3) Subdivision 820-EAA applies in relation to a debt deduction for an income year that begins on or after 1 July 2024 regardless of when the financial arrangement to which the debt deduction relates was entered into."*

The restructure anti-avoidance provision in s.820-423D is part of Subdivision 820-EAA (the debt deduction limitation rules). As such, the restructure anti-avoidance provision will not apply until 1 July 2024 in relation to financial arrangements entered into before 22 June 2023. If the relevant 'bad' related party debt is not in existence at 1 July 2024 then it seems difficult to see how the restructure rule could apply.

The one residual concern with this analysis is the apparent scope of the restructure anti-avoidance rule in s.820-423D (set out above) which can apply to deny debt deductions on the new 'good' third party. As such, a potential interpretation is that when analysing whether the restructure rule denies a debt deduction in relation to a 'good' third party loan post 1 July 2024 the restructure rule can look back at a restructure of a 'bad' third party loan that took place between prior to 1 July 2024.

If this argument was correct then it would bring within scope not only any restructure that took place between 22 June 2023 and 1 July 2024 but also any such restructure that took place before 22 June 2023 – i.e., the restructure rule would apply on an indefinite historic basis. This cannot be the intention.

Although I think it is relatively clear that restructures of 'bad' related party debt prior to 1 July 2024 are permitted, it would be extremely helpful if Treasury could include a clear statement or example to this effect in the EM.

For completeness, it should also be expected that if a specific restructure anti-avoidance rule did not apply then the risk of Part IVA applying to any such restructure should be low.