



# *What you need to know about the new thin cap rules*

Exposure Draft Legislation

April 2023

Pitcher Partners Advisors Pty Ltd  
80 052 920 206



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## *What we are covering today*



**Three new  
earnings-based  
tests**



**Impact on interest  
deductibility from  
1 July 2023**



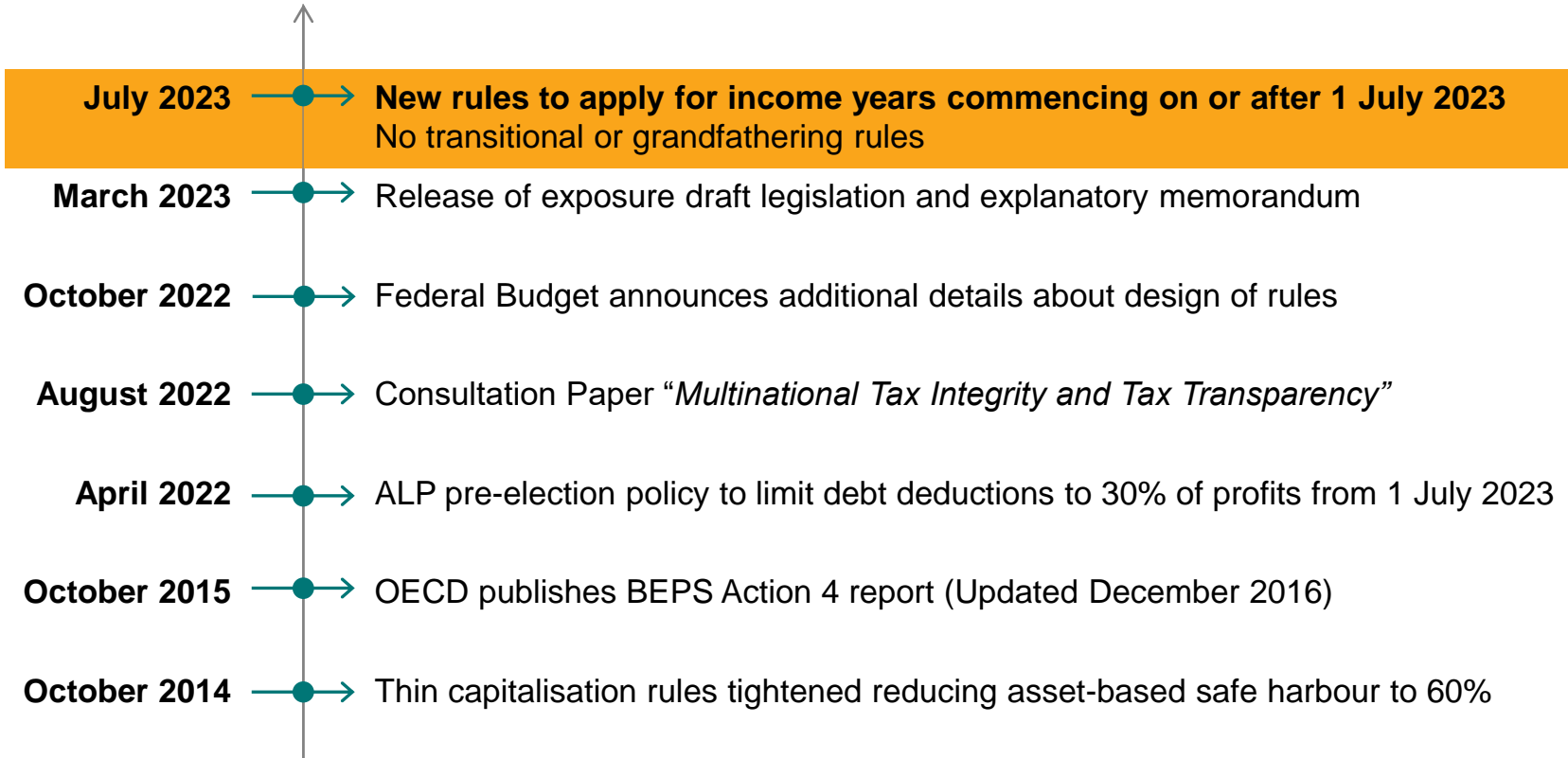
**Thin cap  
calculator tool**



**Next steps**

# New thin capitalisation rules

## Background



# New thin capitalisation rules

## Who is subject to thin cap?

Scope of rules **largely unchanged**



**Entities must have multinational presence**

i.e. “inward” or “outward” entities

Purely domestic entities not subject to thin cap

### Existing exceptions retained

**\$2m**

annual de minimis  
(on “associate entity”  
inclusive-basis)

**90%**

Australian asset exception  
for outward entities



Insolvency remote  
special purpose entities and  
securitisation vehicles



## *Overview of new earnings-based tests*

# Earnings-based thin capitalisation tests

## Overview

### New tests imposing limit on entity's annual debt deductions

#### Fixed Ratio Test

Tax EBITDA x 30%

#### Net debt deductions

Default method

15-year carry forward of denied deductions

#### Group Ratio Test

Tax EBITDA x group ratio

#### Net debt deductions

Elective method

No carry forward of denied amounts & forfeiture of prior

#### External Third-Party Debt Test

Actual debt deductions on eligible borrowings

#### Gross debt deductions

Elective method (one-in, all-in)

No carry forward of denied amounts & forfeiture of prior



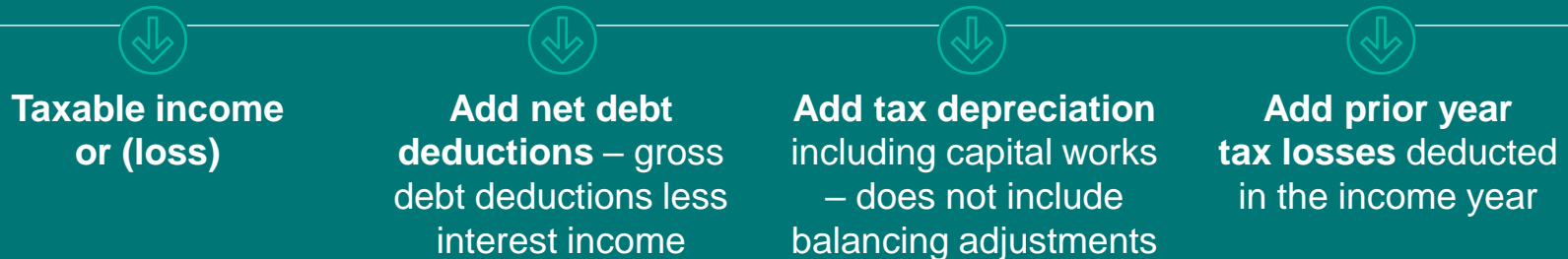
### Applies to “general class investors”

- Entities subject to thin cap
- Not “financial entities”



## *Fixed Ratio Earnings Limit = 30% x Tax EBITDA*

### Tax EBITDA



Excess of **net** debt deductions over Fixed Ratio Earnings Limit are denied



## Fixed Ratio Test

Accounting profit	\$10,000,000
Gross operating income	\$20,000,000
Deductible operating expenses	(\$10,000,000)
Gross interest income	\$100,000
Gross interest deductions	(\$3,700,000)
Tax depreciation	(\$2,400,000)

Assume total assets of \$10,000,000 and total debt of \$6,000,000 (within current safe-harbour)

	Fixed Ratio Test
Taxable Income (Starting)	\$4,000,000
Tax EBITDA	\$10,000,000
Fixed Ratio Earnings Limit	\$3,000,000
Net debt deductions	\$3,600,000
Deductions denied and carried forward	\$600,000
Taxable Income (Final)	\$4,600,000

## Fixed Ratio Test

Accounting loss	(\$5,000,000)
Gross operating income	\$10,000,000
Deductible operating expenses	(\$8,000,000)
Interest deductions	(\$3,000,000)
Tax depreciation	(\$2,000,000)

**Assume total assets of \$10,000,000 and total debt of \$6,000,000 (within current safe-harbour)**

Fixed Ratio Test	
Tax Loss (Starting)	(\$3,000,000)
Tax EBITDA	\$2,000,000
Fixed Ratio Earnings Limit	\$600,000
Net debt deductions	\$3,000,000
Deductions denied & carried forward	\$2,400,000
Taxable Loss (Final)	(\$600,000)

In loss scenarios, tax losses **effectively converted** to carry-forward FRT disallowed amounts

## Fixed Ratio Test

<b>Accounting loss</b>	(\$1,000,000)
<b>Gross operating income</b>	\$10,000,000
<b>Deductible operating expenses</b>	(\$6,000,000)
<b>Interest deductions</b>	(\$3,000,000)
<b>Tax depreciation</b>	(\$500,000)
<b>Tax losses deducted</b>	(\$500,000)

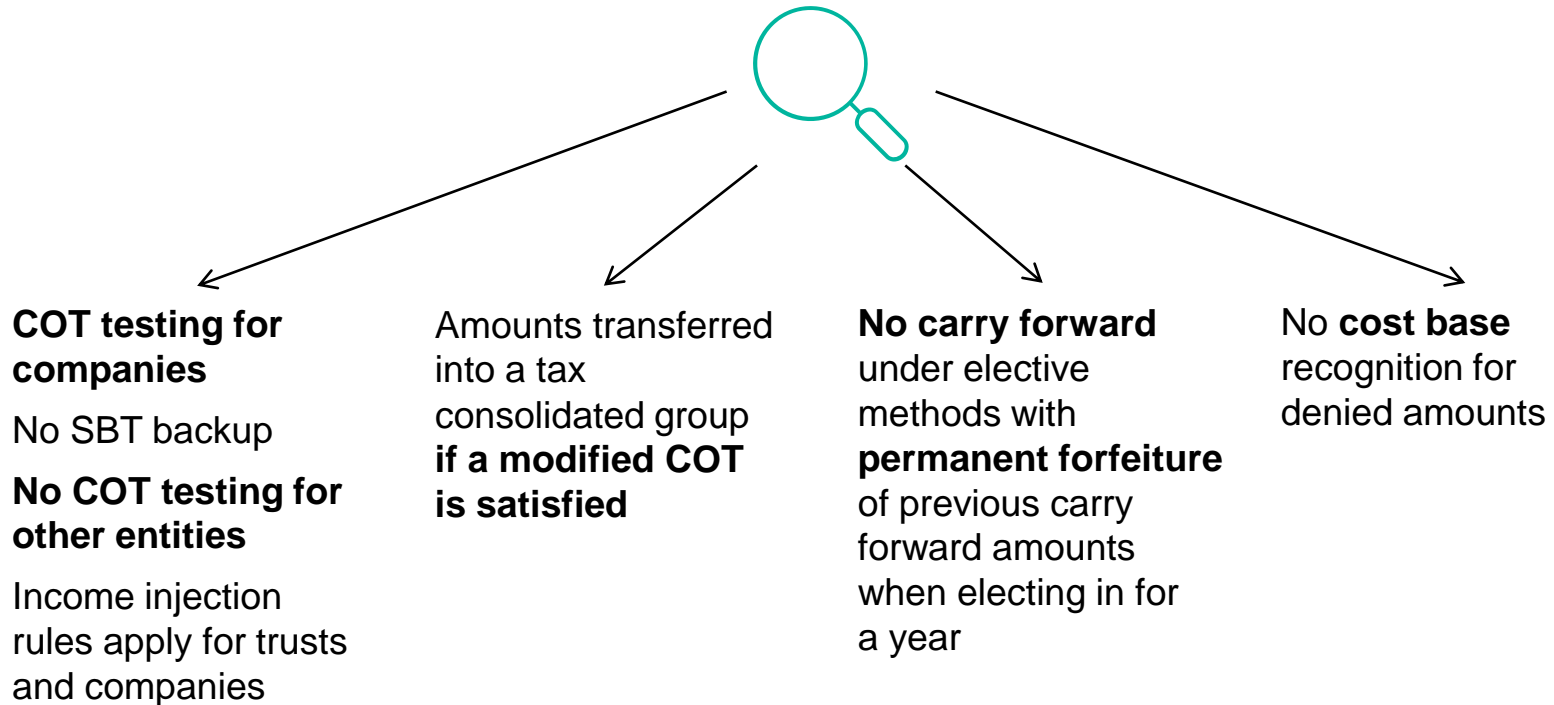
**Assume total assets of \$10,000,000 and total debt of \$6,000,000 (within current safe-harbour)**

Fixed Ratio Test	
<b>Taxable Income (Starting)</b>	\$0
<b>Tax EBITDA</b>	\$4,000,000
<b>Fixed Ratio Earnings Limit</b>	\$1,200,000
<b>Net debt deductions</b>	\$3,000,000
<b>Deductions denied &amp; carried forward</b>	\$1,800,000
<b>Taxable Income (Final)</b>	\$1,800,000

# Fixed Ratio Test

## Carry forward rule

Able to be carried forward FRT disallowed amounts for the **next 15 years** following the denial



## Fixed Ratio Test

Later year deduction is excess of **FRT limit** over **net debt deductions** for the year

	Year 1	Year 2
Net operating income	\$100,000	\$100,000
Interest deductions	(\$80,000)	-
Interest income	\$10,000	-
	<b>Fixed Ratio Test</b>	<b>Fixed Ratio Test</b>
Taxable Income (Starting)	\$30,000	\$100,000
Tax EBITDA	\$100,000	\$100,000
Fixed Ratio Earnings Limit	\$30,000	\$30,000
Net debt deductions	\$70,000	-
Deductions denied	\$40,000	-
Carry forward balance	\$40,000	\$10,000
Utilisation of prior year disallowed FRT amounts	-	\$30,000
Taxable Income (Final)	\$70,000	\$70,000

# Fixed Ratio Test

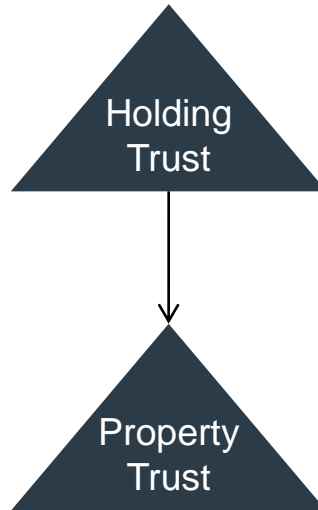
## Grouping issues

**No** carry forward of excess capacity **OR**  
ability to pick up excess capacity of associates

### Tax items

**\$1,000** interest deductions  
(to fund equity in subsidiary)

**\$10,000** net rental income  
**\$2,000** net interest deductions  
**\$6,000** tax depreciation



### Result of Fixed Ratio Test

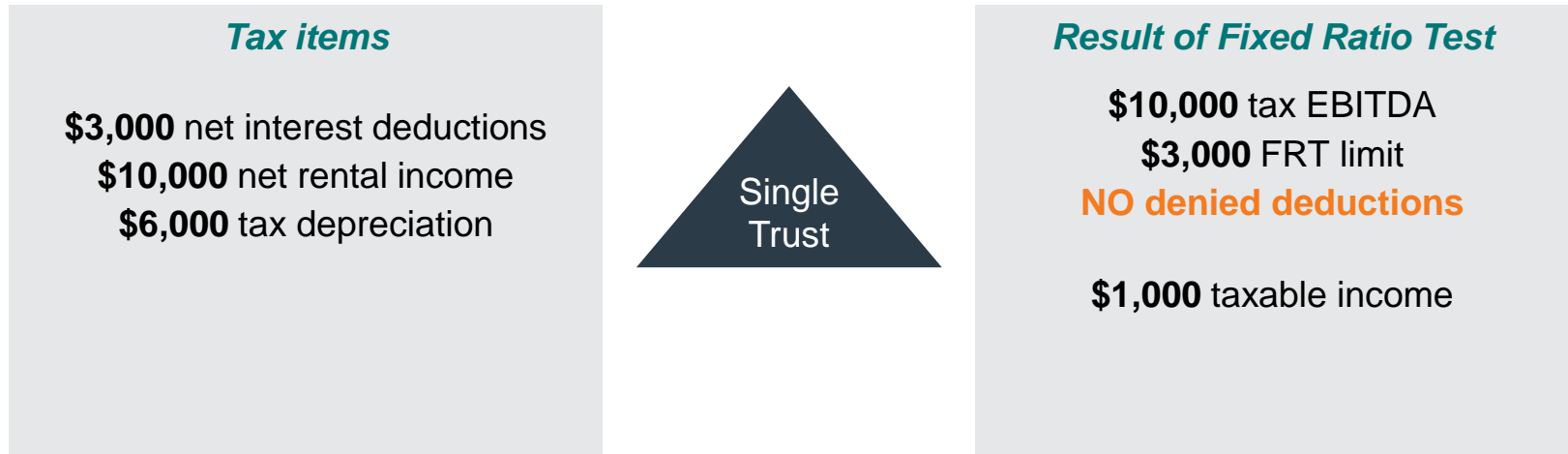
**\$2,000** Tax EBITDA (distribution)  
**\$600** FRT limit  
**\$400 interest denied**  
**\$1,400** taxable income

**\$10,000** Tax EBITDA  
**\$3,000** FRT limit  
**Interest fully deductible**  
**\$1,000** “excess” over FRT limit

# Fixed Ratio Test

## Grouping issues

**Aggregation** into single entity effectively utilises excess capacity



## Fixed Ratio Test – Restructuring arrangements

Accounting profit	\$10,000,000
Gross operating income	\$20,000,000
Deductible operating expenses	(\$10,000,000)
Gross interest income	\$100,000
Gross interest deductions	(\$3,700,000)
Tax depreciation	(\$2,400,000)

**Assume total assets of \$10,000,000 and total debt of \$6,000,000 (within current safe-harbour)**

	Fixed Ratio Test	Extra interest income	Extra operating income
<b>Taxable Income (Starting)</b>	\$4,000,000	\$4,600,000	\$6,000,000
<b>Tax EBITDA</b>	\$10,000,000	\$10,000,000	\$12,000,000
<b>Fixed Ratio Earnings Limit</b>	\$3,000,000	\$3,000,000	\$3,600,000
<b>Net debt deductions</b>	\$3,600,000	\$3,000,000	\$3,600,000
<b>Deductions denied &amp; carried forward</b>	\$600,000	\$0	\$0
<b>Taxable Income (Final)</b>	\$4,600,000	\$4,600,000	\$6,000,000

Beware potential application of **Part IVA** for restructuring to maximise deduction





# *Group Ratio Earnings Limit = Tax EBITDA x Group Ratio*

## *Group Ratio Test*

- Excess of **net** debt deductions over Group Ratio Limit denied
- Based on audited consolidated financial statements
- Requires irrevocable election for the year by tax return lodgment day
- Election invalid if Group EBITDA is negative
- No carry forward of denied deductions



# Group Ratio Test

As disclosed in audited consolidated financial statements

**Include interest-like amounts** and exclude amounts from dealings with associate entities (on a 10%+ control basis)

$$\text{Group Ratio} = \frac{\text{Group net third party interest expense}}{\text{Group EBITDA}}$$

Net profit (before tax expenses) + net interest expense + depreciation and amortisation expenses

**Similar adjustment** for interest-like amounts and associate entity dealings

**Exclude individual entities** with a negative EBITDA

# Group Ratio Test

Aus Co	
Net operating income	\$1,000,000
Net interest expenses (third party)	(\$500,000)
Net interest expenses (associate)	(\$150,000)
Interest income	\$50,000
Tax depreciation	(\$200,000)

Aus Co worldwide group		
Net profit (before taxes)	\$50,000,000	A
Net interest expenses (total)	(\$70,000,000)	B
Net interest expenses (associate)	(\$20,000,000)	C
Sum of negative EBITDA entities	(\$10,000,000)	D
Depreciation and amortisation	(\$15,000,000)	E

## Group Ratio

$$\frac{\$70,000,000 \text{ (B)} - \$20,000,000 \text{ (C)}}{\$50,000,000 \text{ (A)} + \$70,000,000 \text{ (B)} - \$20,000,000 \text{ (C)} + \$10,000,000 \text{ (D)} + \$15,000,000 \text{ (E)}} = \frac{\$50,000,000}{\$125,000,000} = 40\%$$

## Group Ratio Test

	Fixed Ratio Test	Group Ratio Test
<b>Taxable Income (Starting)</b>	\$200,000	\$200,000
<b>Tax EBITDA</b>	\$1,000,000	\$1,000,000
<b>Applicable Ratio</b>	30%	40%
<b>Earnings Limit</b>	\$300,000	\$400,000
<b>Net debt deductions</b>	\$600,000	\$600,000
<b>Deductions denied</b>	\$300,000 (carry forward)	\$200,000 (permanent denial)
<b>Taxable Income (Final)</b>	\$500,000	\$400,000

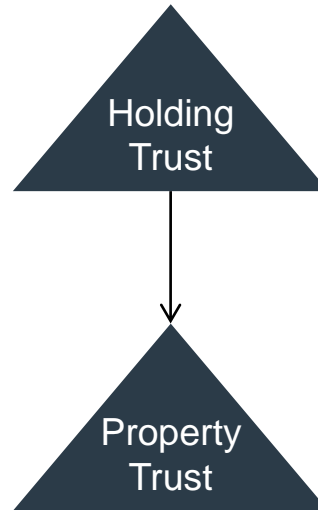
# Group Ratio Test

## Tax vs accounting impacts

### Tax items

**\$1,000** interest deductions  
(to fund equity in subsidiary)

**\$10,000** net rental income  
**\$2,000** net interest deductions  
**\$6,000** tax depreciation



	Group financial statements Year 1	Group financial statements Year 2
Net rental income	\$10,000	\$10,000
Interest expense	\$3,000	\$3,000
Asset revaluation / (impairment)	\$20,000	(\$9,000)
Depreciation and amortisation	\$0	\$0
Net third party interest	\$3,000	\$3,000
<b>Group EBITDA</b>	<b>\$30,000</b>	<b>\$1,000</b>
Group ratio	$\frac{\$3,000}{\$30,000}$ = 10%	$\frac{\$3,000}{\$1,000}$ = 300%



## ***External Third Party Debt Test***

Allows entity to deduct interest to extent of genuine third-party borrowings

Replaces arm's length debt test for general class investors AND financial entities (non-ADIs)

Requires irrevocable election for the year by tax return lodgment day

One-in, all-in requiring all associate entities subject to thin cap to make same election for the year (other than financial entities)

No carry forward of denied deductions



# External Third Party (ETP) Debt Test

Disallows excess of **gross** debt deductions over ETP earnings limit

**ETP earnings limit = Actual deductions for the year incurred  
in relation to external third-party debt**



**Debt must be issued to and held by** non-associate entity  
(on a 10%+ control basis)

No requirement to be issued to  
“commercial lending institution”



**Lender has no recourse**  
beyond entity’s assets

Cross-collateralisation  
may cause failure



**Funds from third party lender solely used** to fund  
Australian investments  
and/or operations

Failure of single condition could result in **nil ETP earnings limit** as election may remain valid

# External third party debt test

## Conduit financier rule

### Allows related-party debt to satisfy external third-party conditions

#### Conduit financier

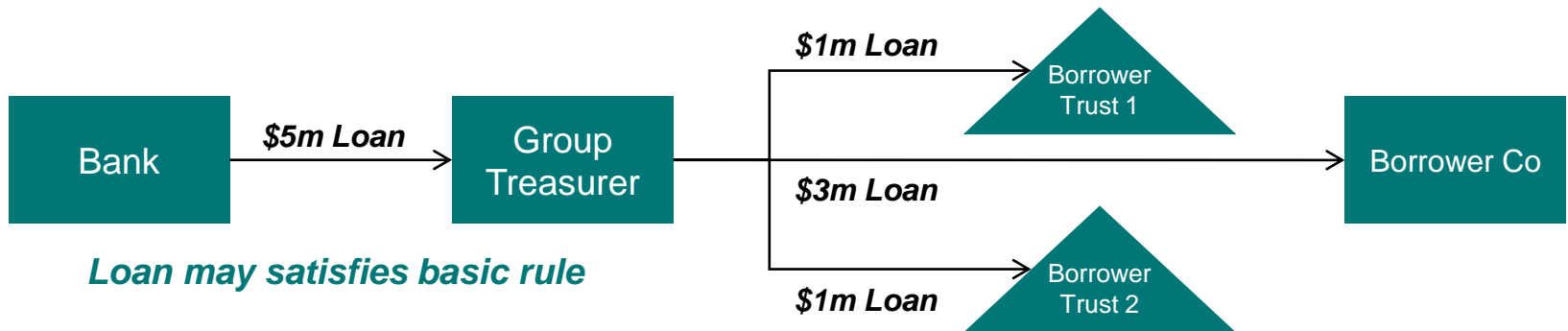
Raises external debt that meets conditions

#### One or more associated borrowers

Issue debt to conduit financier  
Financed by conduit financier only from proceeds of external debt

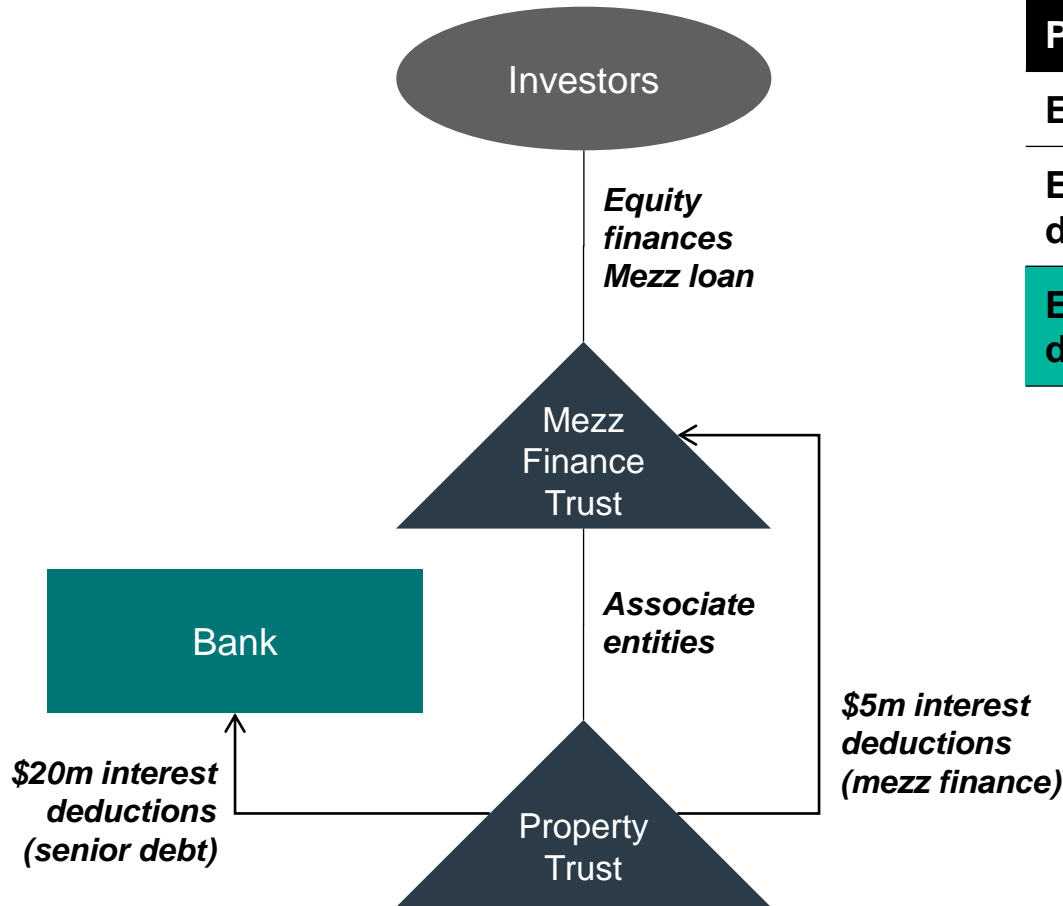
#### Further conditions

Amounts on-lent on same terms  
External lender recourse limited to assets of conduit financier and all borrowers  
Additional election required





# External third party debt test



## Property Trust

<b>ETP earnings limit</b>	\$20m
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<b>Excess debt deductions denied</b>	\$5m
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**Effectively denies all related-party debt deductions**

## External third party debt test

### Aus Co

Net operating income \$1,000,000

Net interest expenses (third party) (\$500,000)

Net interest expenses (associate) (\$150,000)

Interest income \$50,000

Tax depreciation (\$200,000)

### Aus Co worldwide group

Net profit (before taxes) \$50,000,000

Net interest expenses (total) (\$70,000,000)

Net interest expenses (associated) (\$20,000,000)

Sum of negative EBITDA entities (\$10,000,000)

Depreciation and amortisation (\$15,000,000)

## External third party debt test

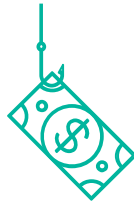
	Fixed Ratio Test	Group Ratio Test	External third party debt test
<b>Taxable Income (Starting)</b>	\$200,000	\$200,000	\$200,000
<b>Tax EBITDA</b>	\$1,000,000	\$1,000,000	N/A
<b>Applicable Ratio</b>	30%	40%	N/A
<b>Earnings Limit</b>	\$300,000	\$400,000	\$500,000
<b>Gross debt deductions</b>			\$650,000
<b>Net debt deductions</b>	\$600,000	\$600,000	
<b>Deductions denied</b>	\$300,000 (carry forward)	\$200,000 (permanent denial)	\$150,000 (permanent denial)
<b>Taxable Income (Final)</b>	\$500,000	\$400,000	\$350,000

# Other changes in Exposure Draft



## Repeal of section 25-90 deduction

Interest to fund tax-exempt foreign dividends to become non-deductible



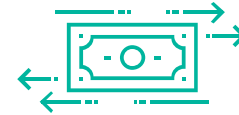
## Expanded meaning of debt deduction

Not limited to amounts incurred in relation to debt interests



## Limiting scope of “financial entity”

Removal of *Financial Sector (Collection of Data) Act 2001* registered corporations



## Transfer pricing amendments

Transfer pricing analysis must now consider both quantum and price of related-party cross-border debt

## *Next steps*

# 1 July 2023 Start Date



### **Model 2024 and later income year outcomes**

Consider feasibility  
of elective methods



### **Review structure of financing arrangements**

Consider restructuring existing  
borrowings and future funding mix

## **Monitor release of final legislation**

# Pitcher Partners Thin Cap Tool

THE PP EARNINGS BASED MODEL GROUP  
EARNINGS BASED THIN CAPITALISATION MODULE  
FOR THE INCOME YEAR 30 JUNE 2023  
CLIENT DATABASE INFORMATION

Refresh All Data

Entity detail database

VARIABLES SUMMARY FIXED RATIO LIMIT GROUP RATIO LIMIT EXTERNAL LIMIT TAX INCOME

Entities 16

Autocomplete	Autocomplete	Autocomplete	Autocomplete	Autocomplete
Yes	Yes	Yes	Yes	No

Abbrv	Name	Associate entity group
1	Big Bird Trust	A
2	Elmo Trust	A
3	Count Trust	A
4	Snuffa Trust	A
5	Cookie Trust	A
6	Oscar Trust	A
7	XYZ Pty Ltd	A
8	ABC Pty Ltd	A
9	MNO Pty Ltd	A
10	Grover Trust	A
11	Abby Trust	A
12	Bert Trust	A
13	Ernie Trust	A
14	Kermit Trust	A
15	Guy Trust	A
Group	Group Accs	A

**SUMMARY RESULTS FOR EARNINGS LIMIT METHODS**

CALCULATION	CALC	REFERENCE	WP REF	Entity 1	Entity 2
ASSOCIATE ENTITY GROUP DETAILS				A	A
ENTITY CLASS				Entity	Entity
TYPE OF ENTITY				Trust	Trust
ETL applies to all associate entities >= 10%				No	No
GRT election				Yes	Yes
Election to use the GRT method				Yes	Yes
GRT cannot be elected where the entity must chose the ETL method					
<b>Total denied deductions under the chosen method</b>					
Method chosen				GRT Method	GRT Method
<b>Total denied deductions</b>			1,921,346	233,274	0

# Q&A



## Contact US



**Alexis  
Kokkinos**  
Partner,  
Pitcher Partners

Alexis.Kokkinos@  
pitcher.com.au



**Leo  
Gouzenfiter**  
Client Director,  
Pitcher Partners

Leo.Gouzenfiter@  
pitcher.com.au



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