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Thin capitalisation legislation introduced into Parliament

26 July 2023

Pitcher Partners Advisors Pty Ltd
ABN 80 052 920 206



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Tests limiting annual debt deductions

Recap



Applies to “general class investors”

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

New tests imposing limit on entity’s annual debt deductions

Fixed Ratio Test (FRT)

Tax EBITDA x 30%

Net debt deductions

Default method

15-year carry forward of denied deductions

Group Ratio Test (GRT)

Tax EBITDA x group ratio

Net debt deductions

Elective method

No carry forward of denied deductions

Forfeiture of prior year FRT denied deductions

Third Party Debt Test (TPDT)

Actual debt deductions on eligible borrowings

Gross debt deductions

Elective method

No carry forward of denied deductions

Forfeiture of prior year FRT denied deductions

Exposure draft to current Bill

What has remained the same?



Start date

1 July 2023

No transitional rules
or grandfathering



Existing exceptions retained

\$2m debt deductions annual
de minimis (on an “associate
entity” inclusive basis)

90% Australian assets for
outward entities*



Transfer pricing amendments

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

* *Exception does not apply to debt creation rules*

What has changed?



Calculation of Tax EBITDA

Now excludes prior year tax losses, franking credits, dividends and certain trust and partnership distributions

Expansion of capital allowance deductions added back



Carry forward of FRT disallowed amounts

Companies – COT and BCT

Trusts – Trust loss rules

Partnerships – No tests



Third party debt test

Mutual election requirement by associate entities removed

Introduction of deemed TPDT choice by members of “obligor group”

What has changed?



Ability to revoke GRT and TPDT elections

GRT and TPDT election can now be revoked if Commissioner allows



Retention of section 25-90 deduction

Repeal of section 25-90 to be reconsidered in a separate process



Debt creation rules

Permanent denial of debt deductions to:

- Borrowings used to acquire an asset (or obligation) from an associate
- Borrowings from associate used to make payments or distributions to an associate

Fixed Ratio Earnings Limit

Fixed Ratio Earnings Limit = 30% x Tax EBITDA

Tax EBITDA

**Taxable income
or (loss)**

+

**Net debt
deductions**
Gross debt
deductions less
interest income

+

**Tax depreciation
including capital
works and balancing
adjustment losses
(but excluding 100%
write-offs)**

-

**Franking credits
Dividend income
Trust and
partnership
distributions from
associate entities**

Excess of net debt deductions over Fixed Ratio Earnings Limit denied
BUT can be carried forward for 15 years, subject to satisfying company
and trust loss rules

Fixed Ratio Test

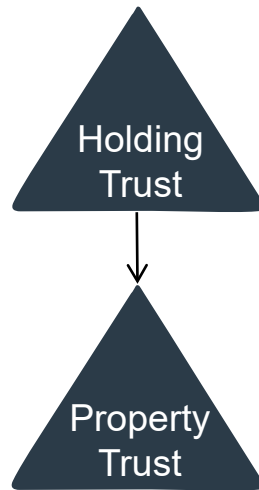
Later year deduction is excess of **FRT limit** over **net debt deductions** for the year

	Year 1	Year 2
Net operating income	\$100,000	\$100,000
Interest deductions	(\$80,000)	-
Interest income	\$10,000	-
	Fixed Ratio Test	Fixed Ratio Test
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

Grouping

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

<i>Tax items</i>
\$1,000 net interest deductions (to fund equity in subsidiary)
\$2,000 distribution from Property Trust
\$10,000 net rental income
\$2,000 net interest deductions
\$6,000 tax depreciation

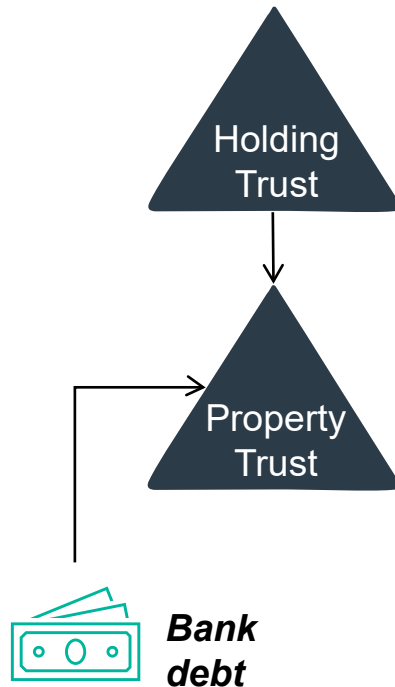


<i>Result of Fixed Ratio Test</i>
\$0 Tax EBITDA
\$0 FRT limit
\$1,000 interest denied
\$2,000 taxable income
\$10,000 Tax EBITDA
\$3,000 FRT limit
\$1,000 excess capacity
\$2,000 taxable income

Contrasting scenarios

Tax items

- \$1,000 distribution from Property Trust
- \$10,000 net rental income
- \$3,000 net interest deductions
- \$6,000 tax depreciation



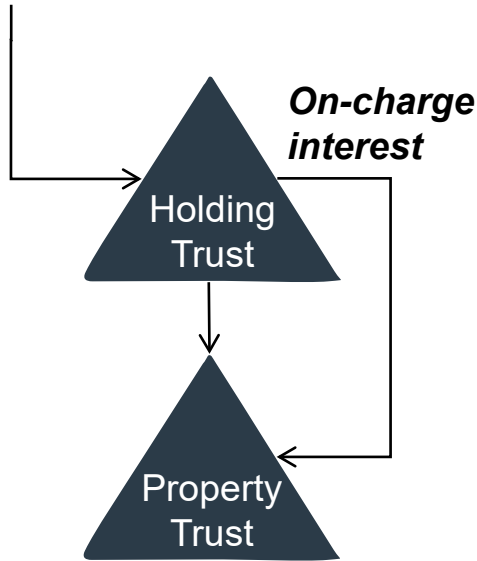
Result of Fixed Ratio Test

- \$0 Tax EBITDA
- \$0 FRT limit
- No interest deductions denied**
- \$10,000 Tax EBITDA
- \$3,000 FRT limit
- Interest fully deductible**

Contrasting scenarios



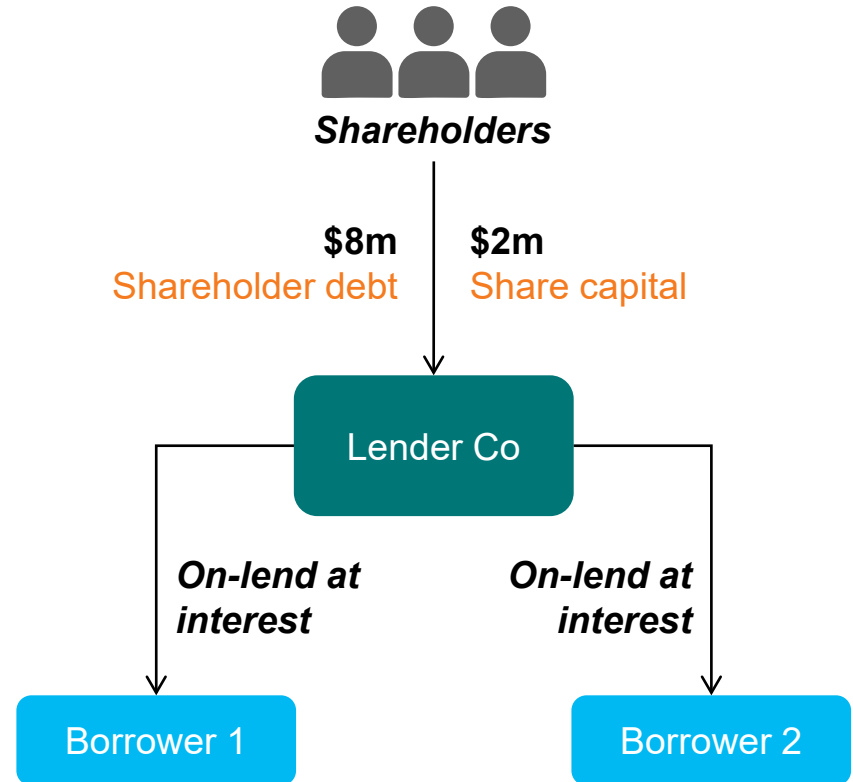
<i>Tax items</i>
\$1,000 interest income
\$1,000 interest deductions
\$1,000 distribution
\$10,000 net rental income
\$3,000 net interest deductions
\$6,000 tax depreciation



<i>Result of Fixed Ratio Test</i>
\$0 Tax EBITDA
\$0 FRT limit
\$0 net debt deductions
Interest fully deductible
\$10,000 Tax EBITDA
\$3,000 FRT limit
Interest fully deductible

On-lending arrangements

Balance Sheet		
ASSETS	Loan receivable 1	6,000,000
	Loan receivable 2	4,000,000
	Total assets	10,000,000
LIABILITIES	Shareholder loan (at interest)	8,000,000
	Total liabilities	8,000,000
	Net assets	2,000,000
EQUITY	Issued capital	2,000,000
	Total equity	2,000,000
Profit and loss statement		
	Interest income	1,050,000
	Interest expenses	1,000,000
	Profit / (loss)	50,000



On-lending arrangements

Balance Sheet		
ASSETS	Loan receivable 1	6,000,000
	Loan receivable 2	4,000,000
	Total assets	10,000,000
LIABILITIES	Shareholder loan (at interest)	8,000,000
	Total liabilities	8,000,000
Net assets		2,000,000
EQUITY	Issued capital	2,000,000
	Total equity	2,000,000
Profit and loss statement		
	Interest income	1,050,000
	Interest expenses	1,000,000
	Profit / (loss)	50,000

Existing rules
Maximum allowable debt
 \$6m safe harbour amount
Deductions permanently denied \$250,000

New rules
Fixed Ratio Test
Net debt deductions \$0
Deductions denied \$0

Start-ups carry forward of FRT disallowed amounts

Balance Sheet		Year 1	Year 2
ASSETS	Inventory	4,000,000	5,000,000
	Other assets	1,000,000	1,000,000
	Total assets	5,000,000	6,000,000
LIABILITIES	Bank loan	4,000,000	4,000,000
	Total liabilities	4,000,000	4,000,000
	Net assets	1,000,000	2,000,000
EQUITY	Issued capital	1,000,000	1,000,000
	Retained earnings	-	1,000,000
	Total equity	1,000,000	2,000,000
Profit and loss statement			
	Revenue	1,000,000	3,000,000
	Interest expenses	(400,000)	(400,000)
	Other expenses	(250,000)	(600,000)
	Profit / (loss)	350,000	2,000,000

Start-ups carry forward of FRT disallowed amounts

Balance Sheet		Year 1	Year 2
ASSETS	Inventory	4,000,000	5,000,000
	Other assets	1,000,000	1,000,000
	Total assets	5,000,000	6,000,000
LIABILITIES	Bank loan	4,000,000	4,000,000
	Total liabilities	4,000,000	4,000,000
Net assets		1,000,000	2,000,000
EQUITY	Issued capital	1,000,000	1,000,000
	Retained earnings	-	1,000,000
	Total equity	1,000,000	2,000,000
Profit and loss statement			
	Revenue	1,000,000	3,000,000
	Interest expenses	(400,000)	(400,000)
	Other expenses	(250,000)	(600,000)
	Profit / (loss)	350,000	2,000,000



Existing rules

	Year 1	Year 2
Debt deductions disallowed	100,000	70,000
Taxable income	450,000	2,070,000

Start-ups carry forward of FRT disallowed amounts

Balance Sheet		Year 1	Year 2
ASSETS	Inventory	4,000,000	5,000,000
	Other assets	1,000,000	1,000,000
	Total assets	5,000,000	6,000,000
LIABILITIES	Bank loan	4,000,000	4,000,000
	Total liabilities	4,000,000	4,000,000
Net assets		1,000,000	2,000,000
EQUITY	Issued capital	1,000,000	1,000,000
	Retained earnings	-	1,000,000
	Total equity	1,000,000	2,000,000
Profit and loss statement			
	Revenue	1,000,000	3,000,000
	Interest expenses	(400,000)	(400,000)
	Other expenses	(250,000)	(600,000)
	Profit / (loss)	350,000	2,000,000

New rules FRT

	Year 1	Year 2
Tax EBITDA	750,000	2,400,000
FRT limit	225,000	720,000
Net debt deductions	400,000	400,000
FRT disallowed deductions carried forward	175,000	
Utilisation of prior year disallowed FRT amounts	-	(175,000)
Taxable income	525,000	1,825,000



Group Ratio Earnings Limit

Group Ratio Earnings Limit = Tax EBITDA x Group Ratio



Excess of net debt deductions over Group Ratio Limit denied



Test expanded to apply to groups with either foreign or Australian parents



Based on audited consolidated financial statements



Requires election by tax return lodgment day (year-by-year basis)



No carry forward of denied deductions

Group Ratio Test

As disclosed in consolidated financial statements

Include interest-like or interest-equivalent amounts and exclude amounts from dealings with associate entities (on a 20%+ 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 or interest equivalent amounts and associate entity dealings

Exclude individual entities with a negative EBITDA

Group Ratio Test

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

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

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



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 election by tax return lodgment day (year-by-year basis)

Deemed election by members of “obligor group” and cross-stapled entities

No carry forward of denied deductions



Third Party Debt Test

Direct borrowings from third party

Disallows excess of **gross** debt deductions over third party earnings limit

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



Debt must be issued to and held by non-associate entity (on a 20%+ control basis)



Lender has recourse only to the entity's Australian assets that are not rights* in relation to a guarantee or security



All (or substantially all) funds from third party lender used to fund Australian investments and/or operations

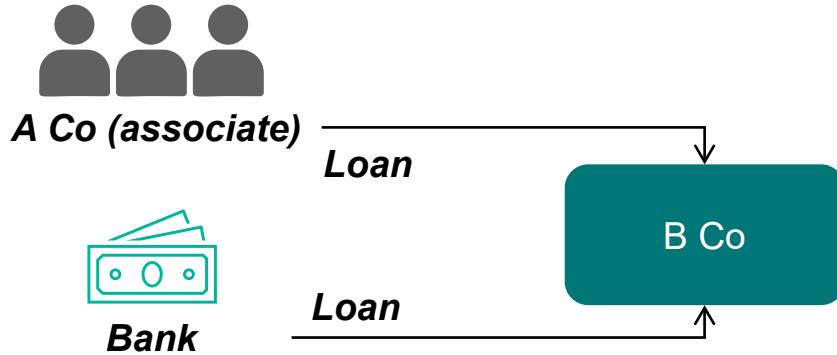


Only Australian tax residents can satisfy this test**

* Except where it relates to the creation or development of real property in Australia

** Excludes trusts and partnerships

Third Party Debt Test



B Co	
Net operating income	\$1,000,000
Interest expenses (third party – Bank)	(\$500,000)
Interest expenses (associate – A Co)	(\$200,000)
Tax EBITDA	\$1,000,000

FRT	
FRT limit	\$300,000
Disallowed deductions carried forward	\$400,000

Deduction claimable under FRT

TPDT	
Third party earnings limit	\$500,000
Deductions disallowed permanently	\$200,000

Deduction claimable under TPDT

Third Party Debt Test

Deemed elections

Deemed TPDT
election made by



Associate entities (on a 20%+ control basis) within the entity's "obligor group" that are required to lodge tax returns

All entities that have entered into a cross-staple arrangement with the entity

Obligor group (for a debt interest)

The borrower

AND

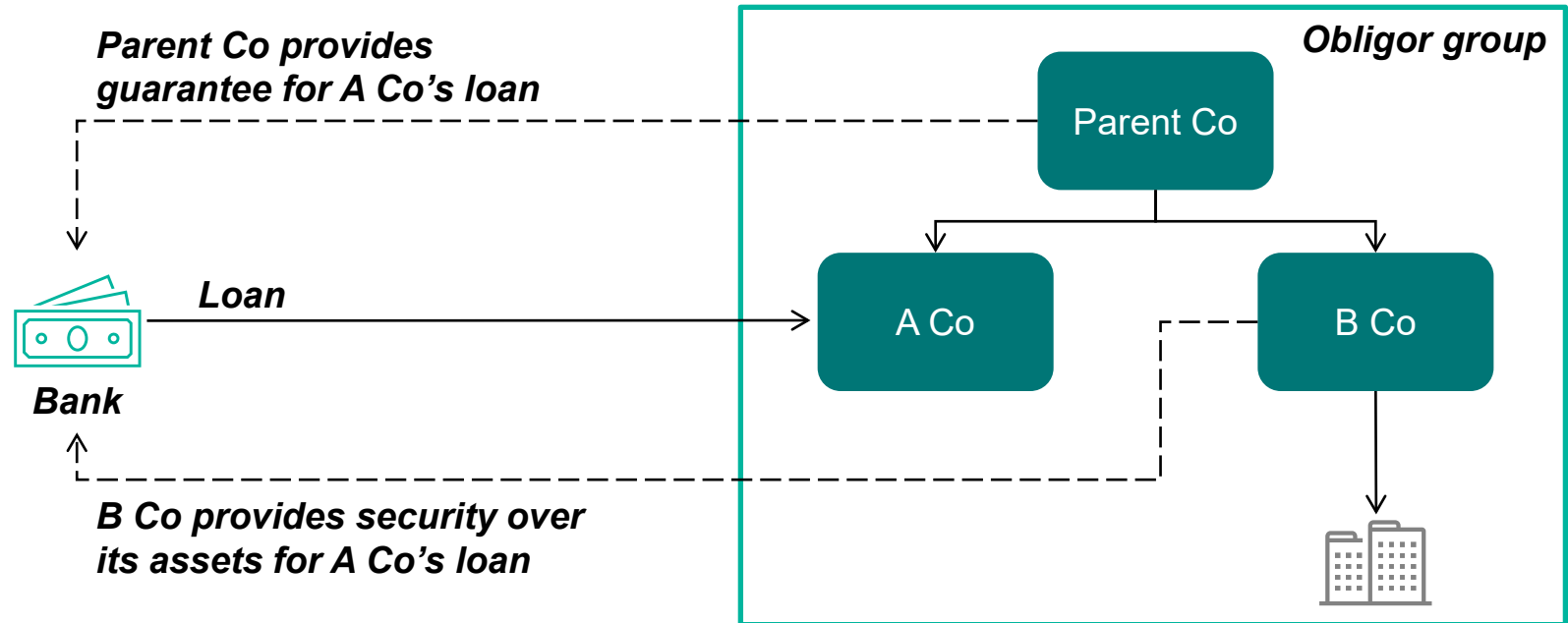
Any entity to which the creditor has recourse to the assets of in relation to the debt interest

Only debt deductions on third party debt are deductible
for entities covered by deemed election

Ability to claim debt deductions on related party debt is lost

Third Party Debt Test

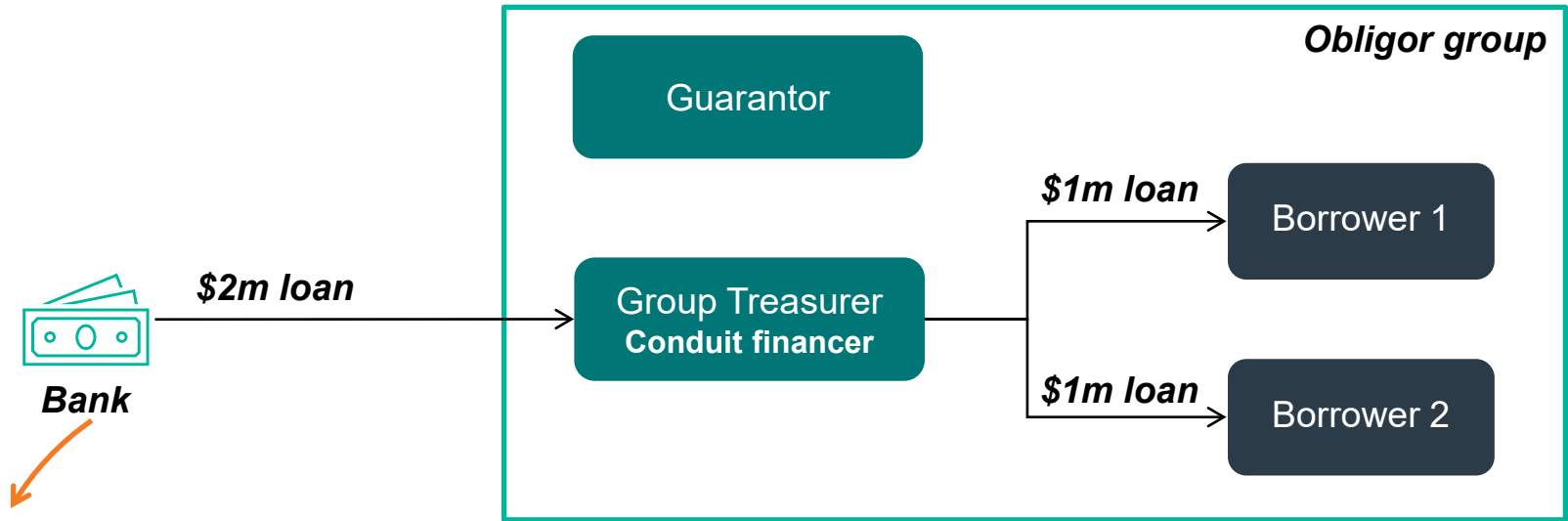
Direct borrowings – recourse to assets



A Co fails the third party debt conditions and cannot claim deductions under the TPDT
Parent Co and B Co can only claim deductions on third party debt

Third Party Debt Test

Conduit financier arrangements



Can have recourse to **Australian assets** of

- Conduit financier
- Members of the conduit financier's obligor group

Loans to borrowers must be

- Financed only from proceeds of external debt
- On the same terms as external debt



Debt creation rules

Only entities that satisfy the \$2m *de minimis* annual debt deductions test are excluded

Intended to be integrity measures but currently have very broad application

No transitional or grandfathering rules – arrangements entered into before 1 July 2023 can be captured



Debt creation rules

Debt deductions disallowed for



Any borrowings used to acquire an asset (or an obligation) from an associate

OR



Borrowings from associates to fund payments or distributions to associates

Debt creation rules

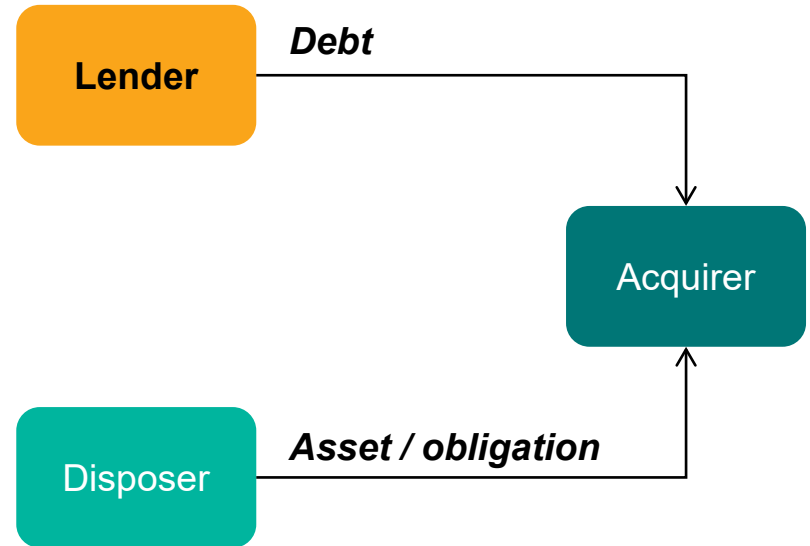
Asset acquisition rule

Debt deductions disallowed where

Acquirer acquires a CGT asset or obligation from a disposer

Debt deductions are incurred in relation to the acquisition of the CGT asset or obligation

Acquirer and **disposer** are associates

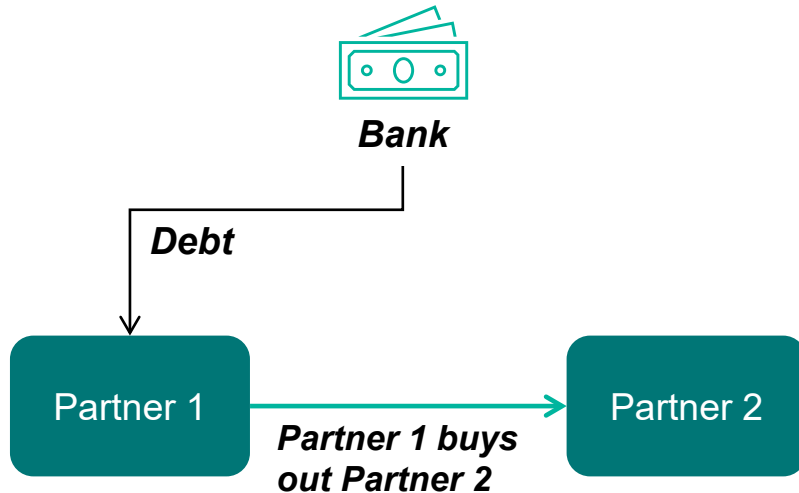


Applies to borrowings that are obtained from **any entity** (related parties or third parties)

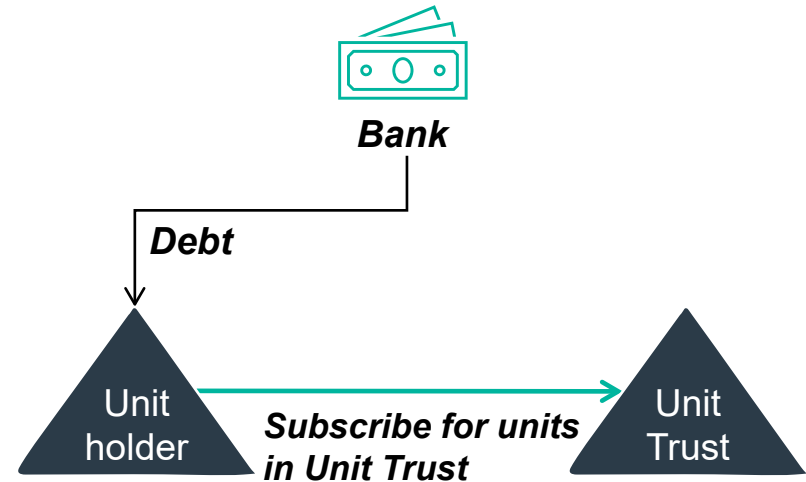
Asset acquisition rule

Examples

Borrowings used to
buy out partner



Borrowings used to
acquire further units in a unit trust



Debt deductions on borrowings are permanently disallowed

Debt creation rules

Payments and distributions rule

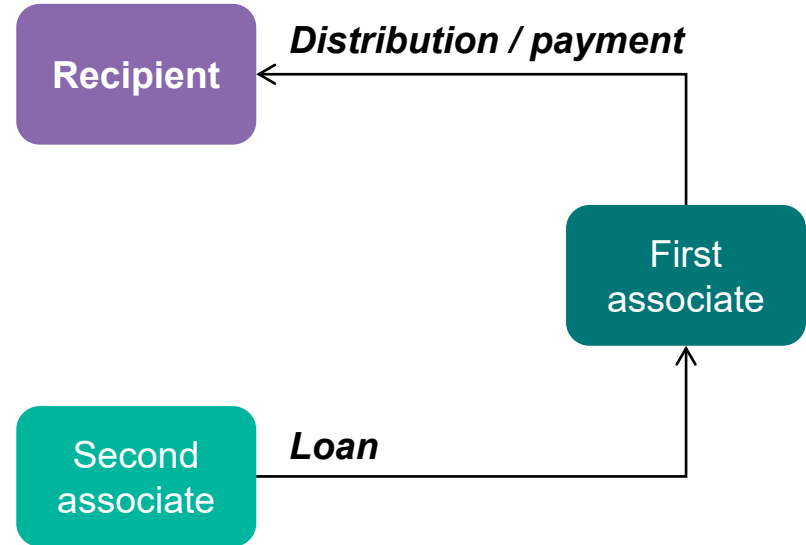
Debt deductions disallowed where

First associate issues debt interest to **second associate**

Debt deductions are incurred in relation to the debt interest

Proceeds used to fund payments or distributions to recipient

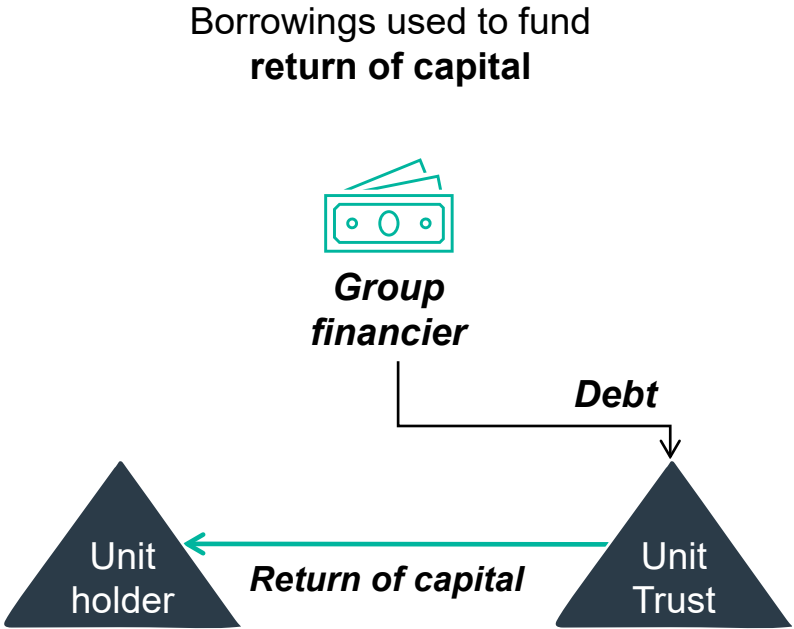
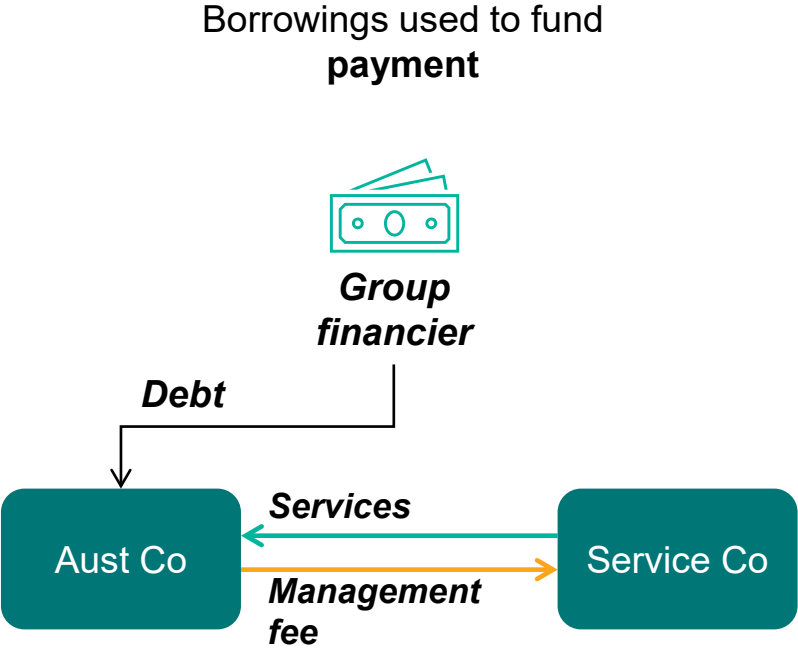
Recipient is an associate of the first associate and/or the second associate



Applies only where borrowings are obtained from related parties

Debt creation rules

Examples for payment or distribution



Debt deductions on borrowings are permanently disallowed

What is Pitcher Partners doing?

Senate submission



\$2m debt deductions *de minimis*

Amend to **net** deductions basis



Adoption of associate entity excess rule

Allow excess debt capacity of downstream entities to be used by upstream entities



Refinement of the TPDT

Allow recourse to assets of borrower and members of the obligor group

Extend access to trusts and partnerships



Revise debt creation rules

Narrow scope to target cross-border profit shifting arrangements as intended

Include carve-outs for ordinary transactions (e.g. purchase of trading stock)

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 any changes to final legislation

Q&A

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