

## TAX SNAPSHOT

### *Thin Capitalisation & Debt Deduction Creation Legislation finalised* – Understanding Key Implications of the new rules and final amendments

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On 27 March 2024, the [Treasury Laws Amendment \(Making Multinationals Pay Their Fair Share – Integrity and Transparency\) Bill 2023 \(Thin Cap & DDC Rules Bill\)](#) finally passed both houses of Parliament and now awaits Royal Assent.

While most of the final [Schedule of amendments made by the Senate](#) primarily incorporated the Government's RU 100 Amendment document (originally released in late 2023 and approved by the Thin Cap & DDC Rules Bill Senate Committee on 5 February) there were the following noteworthy additional cross-bench final Senate amendments:

1. A requirement for an independent review of the Thin Cap & DDC Rules Bill (incorporating further public consultation) to commence on or before 1 February 2026 (with a written report to be provided and tabled in Parliament no later than July/August 2027);
2. A minor adjustment to the s 820-52(1)(c)(i) ITAA 1997 Fixed Ratio Test Tax EBITDA forestry add-back (see page 6 below for details); and
3. A significant carve out in the new application/savings provision (in new s 146) which provides that any entity which meets the new definition of '**Australian plantation forestry entity**' (defined as '*an entity that solely or predominantly carries on a business...of establishing and tending trees for felling in Australia*') will continue to use the pre-existing Div 820 ITAA 1997 Thin Capitalisation provisions for income years commencing 1 July 2023 '**as if the amendments [in Part 1 Schedule 2 of the TC and DDC Rules Bill] had not been made**'. Under new s 146:
  - a. continued application of the existing Div 820 ITAA 1997 '**old law**' by an '*Australian plantation forestry entity*' (as defined) appears to be compulsory rather than a choice (i.e. there appears to be no option for such an entity to choose to use the new Thin Cap and DDC Rules provisions); and
  - b. an '*Australian plantation forestry entity*' (as defined) appears to escape application of both the new Thin Capitalisation and the Subdivision 820-EAA ITAA 1997 Debt Deduction Creation Rules (**DDC Rules**) provisions (given that both form part of Part 1, Schedule 2 of the TC & DDC Rules Bill).

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Subject to the above specific forestry carve out, finalisation of the Thin Cap and DDC Rules Bill now confirms the following outcomes for general investor entities which are subject to the Australian Thin Capitalisation (**Thin Cap**) provisions (which limit Australian debt deductions -often interest costs but also including many broader amounts per the s 820-40 ITAA 1997 definition):

- The new **Thin Capitalisation (Thin Cap)** provisions will apply, usually retrospectively, to **income years commencing from 1 July 2023** (*i.e. an ordinary 30 June balancer will already be 9 months through its first year of the new Thin Cap rules at Royal Assent date*);
- The related (and often more problematic) **Debt Deduction Creation Rules (DDC Rules)** will commence to apply to **income years commencing from 1 July 2024** (*i.e. an ordinary 30 June balancer will have approximately 3 months from Royal Assent to prepare for potential loss of debt deductions under the DDC Rules – although note numerous problematic retrospectivity issues likely to affect many current (and even past) decisions regarding related party debt – see the DDC Rules example diagram and recording at this link - <https://www.taxastute.com.au/group-tax-training-sessions-and-events/>*).

It is important to note that the Third Party Debt Test may, in appropriate cases, provide an effective exception to application of the DDC Rules (via new amended ss 820-423A(2)(g) and (5)(f) ITAA 1997). However, use of the simpler (default) Fixed Ratio Thin Cap Test below will **NOT** be a DDC Rules exception

The outcomes have arisen notwithstanding numerous recent Senate [Consultation Submissions](#) (including Tax Astute Training's submission number 20) and suggestions regarding a variety of requested changes to the Thin Cap Bill, including suggestions to address retrospective Thin Cap Start date.

This Tax Astute Snapshot briefly explains:

- how the final version of the **(default) Fixed Ratio (FR) Test and Tax EBITDA** (Earnings Before Interest Tax Depreciation and Amortisation) **Thin Cap rule** will now operate in practice – see page 3;
- how some practical issues might be resolved via forthcoming **ATO Thin Cap/DDC Rules Consultation** – see page 8; and
- how to access further training and materials regarding the new Thin Cap and DDC Rules now that they have been finalised – see page 9.

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### NOTE

Use this link <https://www.taxastute.com.au/group-tax-training-sessions-and-events/> to review a brief recording example of the separate, but related, Subdiv 820-EAA /TAA 1997 debt deduction creation rules (DDC Rules) which are included in the Thin Cap & DDC Rules Bill and can also deny deductibility for certain related party debt deductions (for income years commencing from 1 July 2024).

### **How will the (default) Fixed Ratio (FR) Test and Tax EBITDA Thin Cap Rule now operate in practice?**

Now that the Thin Cap & DDC Rules Bill awaits Royal Assent, there is certainty regarding how the Tax EBITDA and Fixed Ratio Earnings Limit will be calculated and, in turn, how non-deductible debt deductions (broadly referred to as interest-type deductions in our recording but note the specific definition provisions in the diagram below) might be determined under the (Default) Fixed Ratio Test for income years commencing from 1 July 2023. Understanding this test will allow (most) taxpayers which are subject to Thin Capitalisation as General Investors to either:

- calculate their non-deductible debt deductions (the FRT Disallowed amount shown at page 4 below) which might be deductible within the next 15 years IF a number of carry-forward conditions are met; or
- determine that the Fixed Ratio Test provides a suboptimal result such that the (optional) Thin Cap Third Party Debt Test or Group Ratio Test might be reviewed and chosen instead of the default FR Test rule.

It is expected, however, that the (default) Fixed Ratio Test explained below is likely to be the most commonly used Thin Capitalisation method in practice for income years commencing from 1 July 2023.

The following diagram at page 4 illustrates the broad ‘big picture’ interaction between a taxpayer’s debt deductions, net debt deductions (see A and B below) and the Fixed Ratio Earnings Limit shown at C below. Broadly, the higher the Fixed Ratio Earnings Limit at C then effectively the lower the gap between the (positive) net debt deductions at B and the Fixed Ratio Earnings Limit at C. A lower gap between B and C would, in turn, result in a lower amount of non-deductible debt deductions. These non-deductible amounts are known as the FRT disallowed amount which may (or may not) be able to be carried forward for up to 15 years (see also the note below the page 4 diagram).

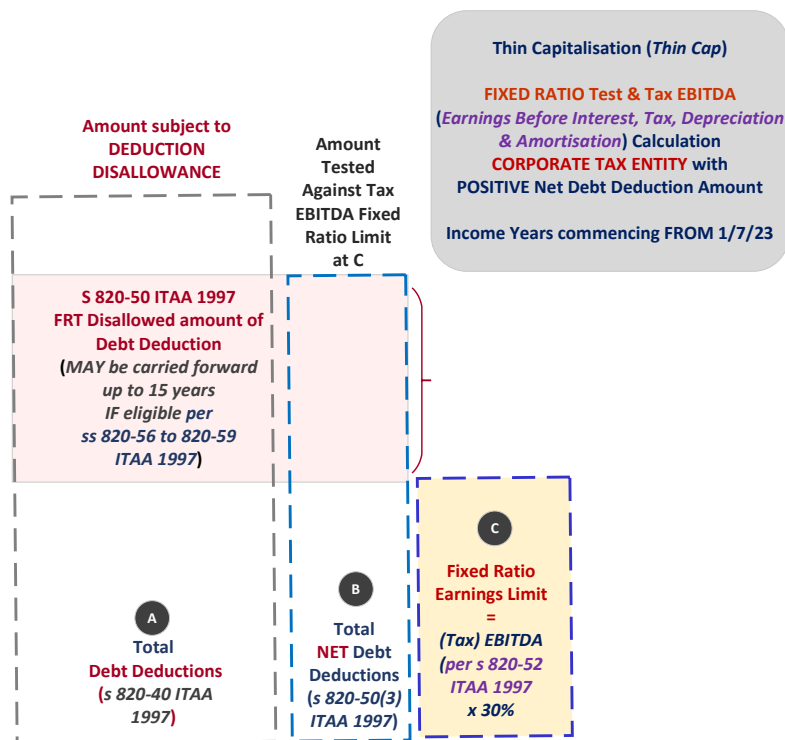
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To watch Tax Astute Training's online explanation of the below diagram, please use this link:  
<http://taxastute.adobeconnect.com/pzp81f2z9ibc/>

This link connects with the Adobe Connect website.

**Note that this content has not changed under the final law since it was recorded in February 2024.**  
(Adobe are a trusted software developer and are the makers of PDF).



**NOTE**

A & B MAY be the same amount if  
NO Interest-type assessable amounts at B

**NOTE**

See the diagram and recording at page 6 below for further calculation details regarding how the Tax EBITDA and Fixed Ratio Earnings limit shown at C is determined.

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### **NOTE**

An advantage of the Fixed Ratio Test (which is NOT available under either of the optional new Thin Capitalisation Tests) is that the non-deductible debt deduction amount (the FRT disallowed amount) MAY be able to be carried and deducted for up to 15 years into the future IF numerous specific conditions are met. Carry forward conditions include, but are not limited to, continual use of the Fixed Ratio Test until the carried forward deduction is claimed, a reversal of the values of B and C at some point within the next 15 years (i.e. any future carried forward deduction would require the future year Fixed Ratio Earnings Limit at C to exceed the Net Debt Deductions at B in the year claimed ) and other important requirements including passing relevant loss tests (e.g. the Continuity of Ownership or Same/Similar Business Test for a company or the Trust Loss Rules for a trust). Importantly, the ability to carry forward and use FRT disallowed amounts is less straightforward than for an ordinary revenue loss for tax and this needs to be recognised when deciding whether or not to use the Fixed Ratio Test.

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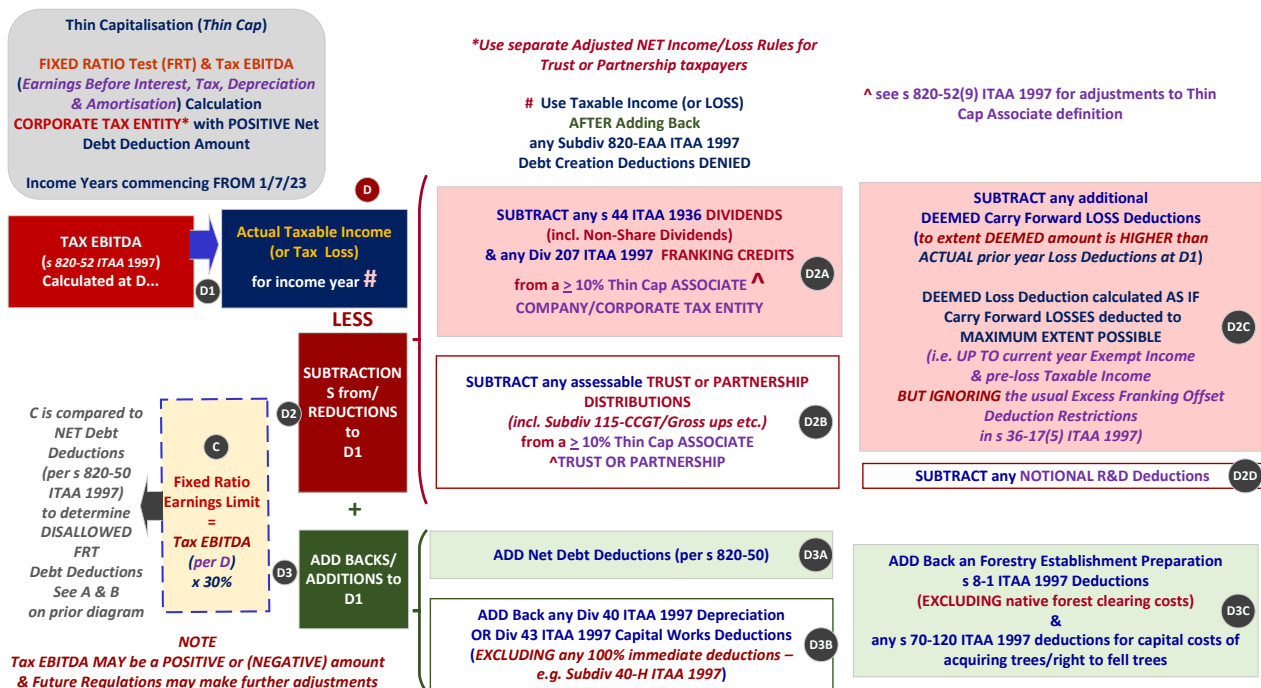
The following diagram illustrates how the Tax EBITDA (which is multiplied by 30% to arrive at the Fixed Ratio Earnings Limit) is calculated under the new Fixed Ratio Test for purposes of planning for and determining the non-deductible debt deduction amount illustrated above. See also further commentary below the diagram.

To watch Tax Astute Training's online explanation of the below diagram, please use this link:

<http://taxastute.adobeconnect.com/plrvf8nl0yqm/>

This link connects with the Adobe Connect website.

(Adobe are a trusted software developer and are the makers of PDF).



#### TIP

As explained in the above recording, broadly treat the Tax EBITDA calculation as having similarities to a tax reconciliation (i.e. traditional add-back and subtraction adjustments made to accounting profit to arrive at taxable income). However, for Tax EBITDA purposes, different additions and subtractions listed above will be added to the actual taxable income (or tax loss) amount for the year in order to determine the Tax EBITDA (which is, in turn, multiplied by 30% to arrive at the fixed ratio earnings limit).

For Tax EBITDA calculation (and Fixed Ratio Earnings Limit) purposes it is generally desirable to maximise the amount determined under the above calculation. For this reason subtractions are a negative, with add-backs a positive outcome.

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**Note the recent carve-out amendment which exclude some eligible Australian forestry entities from ordinary general investor requirements to apply the new Thin Cap and DDC Rules for income years commencing from 1 July 2023 (see page 1 for details).**

While the Tax EBITDA outcome is likely to represent the most simple and effective approach for many taxpayers, in other cases it may illustrate that an optional method such as the Third Party Debt Test should be considered and potentially chosen as an alternative.

**NOTE -**

**Related party dividends and other distributions, current and prior year losses and notional Research and Development (R&D) non-deductible amounts will all have adverse effects when calculating Tax EBITDA (and therefore the Fixed Ratio Limit calculation). If, however, it appears to be likely that the FRT disallowed amount could be carried forward and used in a future year (including via transfer to a tax consolidated group or another eligible associate entity) then this future benefit may outweigh the initial up-front non-deductibility.**

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### Forthcoming ATO Consultation issues

The following consultation details were released on the ATO website (see link at <https://www.ato.gov.au/about-ato/ato-advice-and-guidance/advice-under-development-program/advice-under-development-international-issues#ato-4116Thincapitalisation>) during January 2024.

#### [4116] Thin capitalisation

##### Title

Multinational Tax Integrity – strengthening Australia’s interest limitation (thin capitalisation) rules

##### Purpose

Public consultation on Treasury Laws Amendment (Making Multinationals Pay Their Fair Share-Integrity and Transparency) Bill 2023 has recently concluded.

We are proposing to provide guidance setting out the Commissioner’s views on, and approach to, key aspects of the new thin capitalisation rules.

Stakeholder feedback is sought on potential topics, prioritisation and the form of any potential public advice and guidance.

It is intended that only the most important issues arising from the new law will be addressed through the preparation of early ATO public advice and guidance.

##### Expected completion date

Post enactment (to be determined)

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During Senate Committee Consultation in early 2024, Treasury took the reasonably unusual step of making a submission in relation to its own legislation (see submission 18 at [https://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/GovAmendTLABMultiTax24/Submissions](https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/GovAmendTLABMultiTax24/Submissions)). While the above ATO comments suggest that they may provide practical solutions to, as yet, undetermined ‘*key aspects*’ of the Thin Cap & DDC Rules Bill, Treasury provided the following additional more specific suggestions regarding issues likely to benefit ATO Consultation assistance in its Submission No. 18:

- ATO Guidance regarding entities adversely affected under the DDC Rules in relation to:
  - dividends paid to related parties with a link to related party debt; and
  - business with a high volume of trading stock transactions potentially affected by the DDC Rules) – see page 7 of Treasury Submission.
- ATO Guidance regarding ‘*transitional [DDC Rules] measures to assist taxpayers*’

While the Treasury focussed on problematic DDC Rules issues above, consultation from taxpayers and their advisers is likely to drive future ATO consultation solutions to additional items. (as noted in the ATO excerpt above).

#### TIP -

**Tax Professionals (and their clients) seeking ATO assistance regarding numerous Thin Cap Legislation issues which may be problematic in practice (see the numerous Senate Committee submissions available at [https://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate/Economics/GovAmendTLABMultiTax24/Submissions](https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/GovAmendTLABMultiTax24/Submissions) for examples) is likely to be important to ensure that appropriate practical solutions are offered for problematic issues. See ATO details via the link above. Tax Astute clients (including those attending our Thin Capitalisation and DDC Rules Group Training Events – see below) can ask to have issues confidentially included in Tax Astute Training’s forthcoming ATO submission.**

### **How to access further training and materials regarding the new Thin Cap and DDC Rules provisions**

Further details regarding the DDC Rules and our forthcoming in-depth coverage of all the new rules via our Thin Cap and DDC Rules Group Online Event and associated online recordings may also assist – see <https://www.taxastute.com.au/group-tax-training-sessions-and-events/>.

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In addition to the above Tax Astute Training Recordings, section references and links, see also the Thin Cap Bill's home page at [Treasury Laws Amendment \(Making Multinationals Pay Their Fair Share— Integrity and Transparency\) Bill 2023 – Parliament of Australia \(aph.gov.au\)](https://aph.gov.au/legislation/summaries/bills/2023/13) for the original and Supplementary Explanatory Memorandum and Bill and the [Schedule of amendments made by the Senate](#) for the final version of the Government's RU 100 amendments and additional Independent and Green accepted amendments to the original Bill explained at page 1 above (as at 27 March 2024).

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