Tel: +61 2 9251 4100
Fax: +61 2 9240 9821
www.bdo.com.au

Level 11, 1 Margaret St
Sydney NSW 2000
Australia

By email: MNETaxIntegrity@treasury.gov.au

17 April 2023

International Tax Unit
Corporate and International Tax Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam,

MULTINATIONAL TAX INTEGRITY – STRENGTHENING AUSTRALIA'S INTEREST LIMITATION (THIN CAPITALISATION) RULES - BDO SUBMISSION

BDO refers to the invitation by the Treasury to provide comments on the Exposure Draft *Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation*) (**Draft Bill)** and accompanying Explanatory Memorandum (**EM**). BDO is pleased to provide feedback and comments in relation to the Draft Bill. While it was pleasing to see some of the feedback provided by the Australian tax community in response to the Consultation Paper being reflected in the Draft Bill, there are still some important matters that need to be considered.

The Australian economy's reliance on foreign capital has reduced in recent years with greater availability for Australian sourced capital, particularly from Australian superannuation funds. However a careful balance is required to ensure that any legislation in respect of interest deductions is considerate of the effect on both foreign and Australian sourced capital and achieves a balance in protecting Australia's tax base in preventing excessive profit shifting offshore but also maintaining Australia's attractiveness to both Australian and foreign investment and capital.

One of BDO's primary concerns is that the Draft Bill if enacted, is likely to significantly increase the compliance burden for a wide range of taxpayers, including those who may not have the financial or tax infrastructure to satisfy these requirements. This appears to be particularly applicable to early and mid-life start-up businesses looking to obtain debt funding to fund growth.

Our comments on the Draft Bill are contained in the Appendix that follows this letter. Our comments are structured to directly address the three proposed income-based Thin Capitalisation tests followed by some broader comments on the implications of the new tests and definitions, and the impact of the new legislation to specific groups of taxpayers. However below is an executive summary of the main issues covered by our submission.

Executive Summary

Fixed Ratio Rule

- **Complexity:** As this rule relies on the tax EBITDA, which will usually be very difficult to forecast, it will make it complex for businesses to manage cash flow without having a reasonable approximation of the tax deductibility of their debt deductions.
- **Carry forward of denied debt deductions:** There should be a business continuity test as an alternative to the continuity of ownership test so that it is aligned with the company tax loss tests.
- **Excess debt deductions:** Treasury should consider allowing the transfer of excess debt deductions in a similar manner to the existing “associate entity debt amount” in the safe harbour calculations.

External Third Party Debt Test

- **Conduit financier arrangements:** The requirement for the conduit borrowing to be on exactly the same terms as the original borrowing and be covered by security provided by the ultimate borrower will be almost impossible to satisfy, particularly for cross boarder borrowings, which will be affected by the transfer pricing requirements of the relevant countries.

- **Associate Entities:** The adjustment to the definition of “associate entity” that reduces the control percentage from 50% to 10% and the requirement for associate entities that are exempt from the thin capitalisation rules to elect into the thin capitalisation rules in order for upstream group entities to use the external third party debt test will negatively affect investment decisions to invest in non-controlled subsidiaries.

Group Ratio Test

- **Carry forward of disallowed deductions:** Entities choosing the group ratio test should be allowed to carry forward disallowed debt deductions in a similar manner to the fixed ratio rules.

Denying deductions for NANE income

- **Tracking of NANE debt deductions:** the amendments to sections 25-90 and 230-15 to not allow NANE debt deductions will make it administratively difficult for affected taxpayers because of the need to track the flow of borrowed funds to NANE income production.

- **Do not amend s25-90 and 230-15:** The Government should maintain the s25-90 and s230-15 deductions in relation to NANE income and introduce a similar counterbalance as in the current step 4 of sections 820-95 and 820-100, which reduces the safe harbour debt amounts by the value of the “controlled foreign equity of the entity”.

Broader Comments

- **Impact on specific industries:** There should be alternative thin capitalisation methods for certain industries, particularly the Resources and Infrastructure sectors, which are particularly capital intensive and have long lead times before being profitable. The fixed ratio rule can be very problematic for these sectors.

- **Thin capitalisation exemption threshold**: the current $2 million debt deduction threshold for the exemption in section 820-35 should be increased to reflect inflation over the last 20 years. We suggest a $10 million threshold.
- **Transfer pricing interaction**: The amendments to section 815-140, which currently removes the requirement to determine the arm's length nature of the quantum of the loans for Transfer pricing purposes, will cause taxpayers to incur additional compliance costs. Sufficient guidance needs to be provided on how taxpayers should evaluate the arm's length nature of the quantum of their borrowings following the implementation of these changes.
- **Transitional rules/Grandfathering of existing arrangements:** Many debt arrangement will be difficult if not impossible to renegotiate to take account for the changes to the Australian Thin Capitalisation rules. This could result in Australia being seen as a sovereign risk for investments into Australia. It is suggested that appropriate transitional rule and/or grandfathering of existing arrangements be introduced.

The Draft Bill appears to be largely driven by guidance provided by the OECD in respect of multinational tax integrity and tax transparency. Whilst the OECD guidance is valuable, BDO notes that it is important to acknowledge the contextual nuances in the Australian economy when compared to the other major OECD economies. An opportunity exists to strike a balance between protecting Australia's tax base and ensuring that Australia continues to be a viable and attractive destination for foreign capital. Unnecessarily convoluted compliance requirements may act as a disincentive for foreign investors looking to deploy capital in Australia. Consequently, we urge Treasury to consider the compliance burden that the Draft Bill legislation will have on businesses investing in Australia.

Should you have any questions, or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or lance.cunningham@bdo.com.au.

Yours sincerely

Lance Cunningham

Lance Cunningham

Digitally signed by Lance Cunningham
DN: cn=Lance Cunningham
Date: 2023.04.17 13:19:36 +10'00'

BDO National Tax Technical Leader

BDO Submission to the Treasury
Multinational tax integrity – strengthening Australia's interest limitation (thin capitalisation) rules

BDO has considered the government's Exposure Draft legislation on **Multinational tax integrity - strengthening Australia's interest limitation (thin capitalisation) rules (Draft Bill)** regarding new and previously announced changes to Australia's interest limitation (thin capitalisation) rules. The Draft Bill introduces new earnings-based tests for certain entities, to determine whether to disallow an amount of an entity's debt deductions (e.g. interest) based on the entity's earnings or profits, replacing the current asset-based thin capitalisation tests. We provide the following comments on the Draft Bill.

Fixed Ratio Rule

Replacement of the Safe Harbour Debt Test

The Draft Bill proposes to replace the current Thin Capitalisation safe harbour debt test with an earnings based "Fixed Ratio Rule" test (FRT) with the aim of the test being limitation of net interest deductions to a fixed ratio of Earnings Before Interest, Taxes, Depreciation, and Amortisation (EBITDA). Under this test, it is proposed that net interest deductions be capped at 30% of Tax EBITDA.

We note the OECD's recommendations under Action 4 of the Base Erosion and Profit Shifting (BEPS) Action Plan. The Draft Bill reflects the rationale set out in this plan and specifically the guidance contained in the OECD/G20 Base Erosion and Profit Shifting Project's report, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 – 2016 Update*. Specifically, the report provides a recommended fixed ratio window of between 10-30% of which Treasury is proposing to apply the higher end of this spectrum.

Profit Shifting and Test Complexity

It is submitted that while the FRT calculation methodology is relatively straightforward as a function of tax earnings, additional complexity arises in managing a taxpayer's cash flow and predicting the deductibility of interest expenses year on year with reference to tax EBITDA. The requirement to project tax EBITDA and the fixed ratio earnings limit to determine the deductibility of interest could be burdensome to some businesses, particularly those with fluctuating earnings both during an income year and year on year. In this regard we suggest concessions be provided to allow taxpayers to vary tax instalments with reduced danger of penalties if subsequently the taxpayer's tax EBITDA forecasts prove to be inaccurate, thus resulting in reduced debt deductions and higher tax payable.

Carry Forward of Denied Debt Deductions

It is appreciated that the Draft Bill has included measures to alleviate some of the detrimental effects of the proposed FRT on low revenue and capital-intensive businesses. The Draft Bill allows for denied interest deductions to be carried forward for a period of 15 years. This is achieved by allowing deductions in future years for the carried forward denied deductions of the lesser of:

- the denied deductions carried forward, and
- the excess of the fixed ratio earnings limit for the future income year over the current year net interest deductions.

Whilst this provides assistance for some businesses, such as in a start-up or growth business context, limitations exist for clients experiencing periods of incurring losses, low profit margins, longer profitability lead times due to external factors, or regular long term business cycles.

BDO recommends that Treasury consider in more detail industry life cycles as opposed to adopting a one size fits all approach in this regard. BDO submits that debt deductions for entities with similar gearing levels should not be adversely impacted based on whether an entity has a longer or shorter profitability cycle or inherently lower profit margins.

It is proposed that the carry forward of denied deductions under the FRT will essentially become loss balances which may be utilised in future years, subject to a modified version of the continuity of ownership test relevant for utilisation of carried-forward company tax losses. Generally, companies can currently carry forward and recoup tax losses where they maintain the same majority underlying ownership. It is proposed that this continuity of ownership test would need to be satisfied in order to carry forward denied deductions under the thin capitalisation rules.

However, BDO is concerned that unlike the general company tax loss rules, whether intentionally or otherwise, the proposed amendments do not include an alternative 'business continuity test'. In common commercial arrangements such as mergers and acquisitions where there is likely to be a change in the majority ownership of an entity, failing the continuity of ownership test will result in a loss of carried forward debt deductions. We would request that the government reconsider allowing entities that fail the continuity of ownership test to have the ability to rely on the 'business continuity test' as an alternative to the continuity of ownership test for the purposes of carrying forward denied debt deductions.

Associate Entity Debt Amount

Further, BDO recommends that Treasury consider incorporating into the Draft Bill an equivalent of the "associate entity debt amount" that is in the current safe harbour debt amount calculations by allowing upstream entities within a group (unconsolidated for tax) to utilise any unused fixed ratio earnings limits from subsidiaries within a corporate group, with more than 50% as a proposed minimum control percentage for this purpose.

External Third Party Debt Test

The proposed External Third Party Debt Test (ETPDT) provides prescriptive parameters in allowing tax deductions for interest expenses in relation to debt instruments issued by third party financiers, subject to certain conditions being satisfied. These conditions ensure the ETPDT only captures genuine third party debt which is used wholly to fund Australian business operations. However, the ETPDT is punitive in practice due to related party debt deductions being disallowed and is likely to be unworkable in practice for most taxpayers.

As an alternative BDO suggests that external third party debt be excluded from the adjusted average debt when applying the FRT or group ratio test.

Conduit financer arrangements

We acknowledge the new test may provide an opportunity to claim greater interest deductions for those groups borrowing from third party financiers including conduit financers (i.e. those relatively common commercial arrangements generally implemented to allow one entity in a group to raise funds on behalf of other entities in the group). The Draft Bill's concession in allowing groups to enter into conduit lending arrangements with related parties leading to a third-party financier is somewhat useful in practice.

BDO notes the relative ease of calculating the allowable debt deduction amount when compared to the existing ALDT, with a calculation based on actual third party debt deductions as opposed to the detailed qualitative and quantitative analysis required under the existing ALDT. However, the requirement for the conduit borrowing to be on exactly the same terms as the original borrowing and be covered by security provided by the ultimate borrower will make this concession virtually impossible to apply in most situations. The position is even harder if the conduit finance is coming through foreign group entities as there will be a need to take account of the transfer pricing requirements in Australia and foreign countries, which will generally require some mark up by the conduit financier meaning the terms cannot be the same as the original financing.

"Associate Entity" definition adjustment

The choice to use the ETPDT is further restricted if "associate entities" that are not subject to the thin capitalisation rules have also not made a ETPDT election, see section 820-43(5). The relevant associate entities are those that are not subject to thin capitalisation rule because of sections 820-35, 820-37 and 820-39 (i.e. $2m debt deduction de-minims, the 90% Australia asset threshold and the special purpose vehicle exemption). We refer to these entities below as "thin cap exempt entities" There is also an adjustment to the definition of "associate entity" in Subsection 820-61(9) in administering the ETPDT. The adjustment to the definition has the effect of reducing the relevant control test from 50% to 10% for most entities. This means entities that are not 'associate entities' under the current arm's length debt test may now become so under this new test (i.e. minority investments of 10% or more may now be captured).

If the group includes one of these thin cap exempt entities or has 10% or more equity investment in one of the thin cap exempt entities none of the up stream entities in the group can make a ETPDT choice unless the thin cap exempt entity makes a choice to be subject to the thin capitalisation rule and choose the ETPDT to apply. ..

This means for an entity to elect for the ETPDT to apply, all of its "associated entities" that are thin cap exempt entities must elect into the thin capitalisation rules and to elect to use the ETPDT. BDO views this as practically challenging, particularly where non-controlling interests are held. In these cases. Communication in respect of making the election required under subsection 820-61(6) may not be possible or practical in relation to non-controlled associate entities. Where a non-controlled subsidiary does not make the required election, this precludes the upstream members of the group from eligibility to use the ETPDT. The entity would then be required to use either the FRT or GRT which, depending on the entity's tax EBITDA or EBITDA respectively, may result in a less favourable interest deductibility outcome, even where third party debt is deployed.

The ETPDT also creates problems for acquisitions of new non controlled subsidiaries that are exempt from the thin capitalisation rules. If an entity or group has made a choice to apply the ETPDT, it will not be inclined to acquire a non-controlling interest in a thin cap exempt entity. This causes problems for both the thin cap exempt entity and the potential investing entity. The thin cap exempt entity may lose the opportunity for the equity investment funds that it would otherwise have received, and the potential investing entity would be restricted in its investment choices. These problems would be caused solely because of the tax changes. This appears to be an inappropriate and unintended consequences of the proposed adjustment to the “associate entity” definition.

Accordingly, BDO submits that Treasury reconsider the requirement for associate entities that are thin cap exempt entities to elect into the thin capitalisation regime and also elect to use ETPDT. Alternatively Treasury should at least remove the adjustment to the definition of “associate entity” in subsection 820-61(9) that i.e. by increasing the proposed thin capitalisation control percentage for this purpose from 10% back to 50%.

Group Ratio Test

BDO welcomes the amendments introducing a group ratio test (GRT) that will replace the existing worldwide gearing test for 'general class investors'. The GRT will allow an entity that may be in a highly leveraged group to deduct net debt deductions in excess of the amount permitted under the FRT. The limit is based on a financial ratio of the worldwide group (referred to as the 'group ratio earnings limit') which is calculated by reference to the audited consolidated financial statements of the group parent.

However, BDO is concerned that unlike the FRT, disallowed debt deductions under the GRT cannot be carried forward and claimed as a deduction in subsequent income years. In addition, if there are previously denied deductions under the FRT, and a taxpayer elects in a particular year to utilise the GRT, those denied deductions under the FRT will be lost.

Denying deduction for NANE income and tracing use of borrowings

Section 768-5 of the 1997 Act deems that certain foreign equity distributions are non-assessable non-exempt (NANE) income of an entity. Under current law, sections 25-90 and 230-15 of the 1997 Act also provide that interest expenses incurred to derive this income are deductible, notwithstanding the general principle that expenses incurred in deriving NANE income are not deductible.

The proposed amendments to section 25-90 and section 230-15 will prevent Australian entities being able to deduct interest used to fund investments in foreign entities where the distributions from those foreign entities are NANE income under section 768-5. The rules allowing a deduction relating to exempt foreign income under s25-90 and section 230-15 were originally introduced to allow taxpayers to borrow funds without having to track the use of funds in their business. This concession is counterbalanced with corresponding clawback rules within the current thin cap provisions under step 4 of sections 820-95 and 820-100, which reduces the safe harbour debt amount by the value of the controlled foreign equity of the entity.

The controlled foreign equity is generally aligned with the entity’s equity investments that would pay NANE dividends under section 768-5 and on which sections 25-90 and 230-15 allow debt deductions. This counterbalance to sections 25-90 and 230-15 has worked well to limit the debt deductions in relation to the section 768-5 NANE income by using the thin capitalisation rules while maintaining the ability for taxpayers to not have to track the use of funds.

BDO submits that rather than amending sections 25-90 and 230-15, the Government should maintain the s25-90 and s230-15 deductions in relation to NANE income and introduce a similar counterbalance as in the current step 4 of sections 820-95 and 820-100. This would maintain the current concession not to track the use of funds with the thin capitalisation rules providing a counterbalance to limit debt deductions in relation to the section 768-5 NANE income. BDO suggests Treasury undertakes appropriate consultation with the tax, legal and accounting professions to determine such an appropriate mechanism.

Impact on specific taxpayer groups and industries

Start-up Businesses

The 30% EBITDA net interest limitation under the FRT will likely not be available for most early-stage businesses and start-ups. These businesses typically have little to no revenue in the early stages and may also experience climbing expenditure during growth phases. While the ability to carry forward denied debt deductions for 15 years will be helpful in this regard, if such start-up businesses want to claim debt deductions before passing the FRT in a future year they may have to rely upon the ETPDT in order to access tax deductions for interest expenses. However using the ETPDT could present practical administrative challenges for them to pass the ETPDT and would likely require higher compliance costs. See above for more comments on the ETPDT.

At a time when governments are looking to stamp Australia's place as a leader in global technology and innovation, the fixed ratio model appears to be counter-intuitive to attracting funding for these activities. Reduced foreign capital investment in these businesses will necessitate greater government expenditure in these areas.

Resources Sector

The resources sector is a major contributor to Australia's gross domestic product with a large number of resources projects funded by foreign investment. The Australian Bureau of Statistics recently reported that in FY22 Australia's resources set a new export revenue record totalling $413 billion contributing 69% of Australia's total export revenue. Given the gravity of the resources industry for the Australian economy, the impact to the resources sector should be a primary consideration in determining the appropriateness of any changes to the thin capitalisation rules.

The sector experiences fluctuating profitability which is both cyclical and in response to market conditions. Resources businesses incur significant upfront exploration, development and labour costs in prospecting prior to committing to development, mining and processing resources. Prospecting activities are capital intensive, and entities can in some cases incur sizeable outgoings for substantial periods of time whilst earning little or no revenue during this period. Further, commodity prices can impact sales revenue and therefore profitability once resources are mined and sold.

Given the profitability fluctuations experienced by the resources sector by virtue of both the nature of the resources business cycle and external factors such as commodity pricing, the implementation of the FRT based on earnings is problematic. The earnings basis in the FRT creates great uncertainty for resources businesses due to being unable to forecast deductions for interest expenses with meaningful accuracy.

BDO appreciates that Treasury's intention is to fall within the OECD's guidance in implementing an FRT, but we question the appropriateness of this methodology in an Australian context. An asset-based approach may be more appropriate to allow resources businesses more certainty in forecasting their cost of capital. Increased certainty in this regard would provide more incentive for foreign investment in resources businesses.

Profitability in the resources sector is often cyclical, impacted by commodity prices as well as exploration and development costs and labour costs because many projects require significant exploration investment before they are developed. Given the many factors that can impact profitability and therefore the deductibility of debt under a fixed ratio EBITDA test, a thin capitalisation safe harbour test based on EBITDA would give rise to significant uncertainty when deciding whether to invest in Australian resource projects. Therefore, a fixed ratio EBITDA test may be less fit for purpose for Australia than for the majority of OECD countries.

Infrastructure

Australia is expecting significant foreign migration in addition to an increasingly ageing population. Increased housing, transportation and health infrastructure will be required including further foreign investment to fund these projects. Infrastructure projects are a significant area of expenditure for the federal and state governments. Australia's ability to attract foreign capital to fund these projects is important in reducing pressure on the federal and state governments in funding infrastructure projects.

Infrastructure debt facilities are often asset backed. Profitability for many infrastructure projects can take up to 15 years or more and as such, interest deduction denials are likely during this period under the FTR.

BDO recommends that Treasury consider potential exclusions from the new rules for project infrastructure groups to ensure that Australia remains an attractive destination for foreign infrastructure debt and equity investment. Given that infrastructure projects are generally asset backed, a balance sheet-based approach to thin capitalisation would appear to be more appropriate than the earnings basis in the FRT.

Alternatively, infrastructure investments could be given ample transitional or grandfathering concessions to allow current funding arrangements to be played out so they do not have to be renegotiated partway thought the funding cycle, which in many cases may not be possible or very costly. Without such concessions it could be seen that Australia is creating a sovereign risk.

The Alternative to the FRT for Certain Industries

The 30% EBITDA test may not actually realise a reduction in profit shifting tax planning opportunities. The rule does reduce certainty in relation to the deductibility of interest for businesses and may create uncertainty so as to divert foreign investment away from Australia. If the Government views the existing Safe Harbour Debt Test as being too generous, an alternative may be a reduction in the safe harbour debt threshold of 60% instead of implementing the proposed 30% fixed rate EBITDA test. This solution would likely be more palatable to those industries engaging in businesses with substantial asset holdings, stable returns and slower profitability cycles such as the resources and infrastructure sectors.

Existing thin capitalisation exemption threshold should be increased

BDO welcomes the government's decision to retain the existing thin capitalisation exemptions such as the de minimis threshold for debt deductions of $2 million or less and the 90% Australian assets threshold exemption (for outward investing entities).

However, regarding the existing total debt deductions of $2 million de minimis threshold, we consider that $2 million is not a high enough threshold for the FRT to exclude low-risk entities and therefore should be increased. We suggest that the $2 million de minimis threshold be increased to at least $10 million and indexed periodically going forward. The current $2 million de minimis threshold has not been increased since 1 July 2014 (i.e. 8 years ago) when the threshold was increased from $250,000 before 1 July 2014.

Interaction between transfer pricing rules and thin capitalisation

The amendments to section 815-140(1)(a) removes the concessional treatment in respect of the quantum of loans for general class entities utilising the FRT and the GRT on the basis that these tests are income based. This requires the regulation of the quantum of debt on hand via the transfer pricing rules in addition to the related interest rate.

Currently, the thin capitalisation legislation focuses on determining a maximum allowable debt amount, and the transfer pricing rules only applied to limit the deduction based on the interest rate, where the arm's length interest rate was applied on the actual amount of debt.

However, under the proposed FRT, as the tests do not determine the maximum allowable debt, all general class investors will need to separately consider, support and document the arm's length nature of their debt amount for transfer pricing purposes in addition to calculating any deductibility limitations under any of the proposed new Thin Capitalisation tests.

BDO notes that although the changes to the Transfer pricing rules in 815-140 is in reaction to the introduction of the FRT, all general investors will now be required to undertake analysis of their balance sheets to verify that the quantum of their debt capital is an arm's length amount in addition to any analysis in respect of the thin capitalisation test of choice, which is not currently required. This includes those taxpayers using the FRT or GRT or ETPDT i.e. not just those using the fixed ratio method.

Given the amendments to 815-140 and the removal of the arm's length debt test for general investors (which, while complex to apply and administer was generally well understood by taxpayers and advisors), there will be a lack of guidance in respect of how taxpayers should evaluate the arm's length nature of their borrowings following the implementation of these changes. We therefore recommend that guidance be issued in the form of a practical compliance guideline or taxation ruling to provide taxpayers with some certainty as to the ATO's views as to the most appropriate methods to be applied to assess the arm's length nature of their balance sheet.

Broader Considerations

Timing

BDO submits that the proposal for the legislation to take effect for income years commencing on or after 1 July 2023 is unreasonable. Capitalisation changes often take substantial time and require careful consideration of other commercial factors. Changes to this area of the law will necessitate changes to business funding arrangements including but not limited to debt/equity mixes, consideration to sourcing existing related party finance from third party financiers, broader business modelling and business restructuring.

We consider that the proposal to make effective this legislation for income years commencing on 1 July 2023 does not provide taxpayers with sufficient time to obtain the necessary information and modelling to make an informed commercial decision and to execute any restructure action prior to inception of the legislation. Any transitional period relating to changes to the thin capitalisation rules should be over a much larger time period, namely several years to enable taxpayers to restructure and refinance existing debt facilities in response.

No grandfathering or transitional period

When enacted, the amendments are proposed to operate for income years commencing on or after 1 July 2023 (i.e. in two and half month's time). The draft Bill does not include any grandfathering for existing debt arrangements or any transitional relief. Whether intended or unintended, this means the changes may apply to existing debt, not just borrowings entered into during the income years commencing on or after 1 July 2023. BDO is concerned that without grandfathering or transitional relief, this will be potentially adverse for taxpayers who have borrowed based on the existing safe harbour debt amount and may have modelled the viability of their investments on interest deductions which may cease to be available in the income year commencing after 1 July 2023, when the legislation is planned to take effect.

A model for a transitional approach could be found in the approach taken when introducing amendments for stapled structures, which allowed a 7 to 15 year transitional period to allow existing arrangements to be restructured.

Application of Part IVA to restructure activity

BDO has concerns that the ATO may seek to apply the general anti-avoidance provisions in Part IVA of the ITAA 1936 in respect of restructure activities undertaken in response to restructure activity undertaken by taxpayers in response to the thin capitalisation legislation. A number of taxpayers will likely refinance existing related party debt facilities or look to vary the mechanics of their financing arrangements to manage any adverse impacts. Interest deductibility has been a major driver for taxpayers seeking to fund business operations with debt finance and as such, many taxpayers will look to refinance. BDO recommends that a message be included in the explanatory memorandum that indicates that appropriate restructuring of debt equity arrangements should not be subject to Part IVA. This should ensure the ATO is cautious in its approach to applying Part IVA to restructure activity in response to legislative changes to thin capitalisation.