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Thin capitalisation

Explains how certain entities investing or controlled across the Australian border have their debt deductions limited.

Understanding thin capitalisation

Work out if Australia's thin capitalisation rules apply to you.

Outward investing financial entity (non-ADI)

How an outward investing financial entity (non-ADI) calculates if they have met the thin capitalisation rules.

Inward investment vehicle (financial)

How an inward investment vehicle (financial) calculates whether they have met the thin capitalisation rules.

Inward investor (financial)

How an inward investor (financial) determines if they have met the thin capitalisation rules.

Outward investing entity (ADI)

There are 5 steps an outward investing entity (ADI) takes to

Inward investing entity (ADI)

There are 4 steps an inward investing entity (ADI) takes to calculate if they have met the thin capitalisation rules.

Interaction with other provisions

How the thin capitalisation rules interact with other provisions.

Terms we use

A brief explanation of terms with special meanings and links to where the term is defined in the legislation if needed.

Amendments to the Thin Capitalisation rules – ATO's PAG consultation topics and prioritisation

A summary of PAG topics raised by stakeholders on the new Thin Capitalisation rules and how these will be prioritised.

QC 17057

Interaction with other provisions

How the thin capitalisation rules interact with other provisions.

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Interaction with other provisions

The thin capitalisation rules limit the amount of debt deductions you can claim. Regard must also be given to other provisions in the income tax law, including the transfer pricing rules and the debt deduction creation rules (DDCR).

Transfer pricing

You must apply the transfer pricing rules before applying the thin capitalisation rules.

Debt deductions remaining after the application of the transfer pricing rules may be further disallowed by the thin capitalisation rules.

The *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024*, changed the way that the transfer pricing rules apply to:

- general class investors
- inward and outward investing **financial entities** who choose to apply the **third party debt test** for an income year.

For these businesses, the modification to the transfer pricing rules in section 815-140 of the ITAA 1997 doesn't apply. Therefore, the transfer pricing rules may deny debt deductions on account of both the interest rate and the amount of debt.

For other entities that Division 820 of the ITAA 1997 applies to that are not entities described above, the modification to the transfer pricing rules in section 815-140 of the ITAA 1997 continues to apply.

The debt deduction creation rules

The DDCR are contained in Subdivision 820-EAA of the *Income Tax Assessment Act 1997* (ITAA 1997). They were enacted by the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share—Integrity and Transparency) Act 2024* as part of changes to strengthen the thin capitalisation rules.

For income years starting on or after 1 July 2024, the DDCR disallows related party debt deductions in relation to certain related party arrangements.

There are 2 types of arrangements to which the DDCR applies.

Type 1: Acquisition case

The DDCR may disallow debt deductions where a business acquires a CGT asset, or a legal or equitable obligation from an associate pair.

This applies to all such acquisitions except:

- new membership interests in an Australian entity or foreign company
- new depreciating tangible assets to be used by the acquirer for a taxable purpose in Australia within 12 months. They must not have previously been installed or used by the acquirer, an associate pair or the disposer for a taxable purpose
- new debt interests issued to the acquirer by an associate pair.

Debt deductions that are paid or payable (directly or indirectly) to a related party are disallowed to the extent that they're incurred in relation to the acquisition (or holding) of the CGT asset, or legal or equitable obligation.

Type 2: Payment or distribution case

The DDCR may disallow debt deductions where a business uses a financial arrangement to fund, or facilitate the funding of, prescribed payments or distributions to an associate pair.

Prescribed payments and distributions include:

- dividends, distributions or non-share distributions
- distributions by a trustee or partnership
- returns of capital, including returns of capital made by a distribution or payment made by a trustee or partnership
- cancellations or redemptions of a membership interest
- royalties (or similar payments or distributions for the use of, or right to use, an asset)
- refinancing a debt interest that originally funded a prescribed payment
- payments or distributions of a similar kind to any of the above
- payment prescribed in regulations (no regulations currently exist).

Debt deductions that are paid or payable (directly or indirectly) to a related party in relation to the financial arrangement are disallowed to the same extent that the financial arrangement was used to fund, or facilitate the funding of, one or more prescribed payments or distributions.

Who is affected by the DDCR

The DDCR may disallow debt deductions of the following entities:

- general class investors
- inward and outward investing financial entities.

Who is not affected by the DDCR

The DDCR does not apply to the following entities:

- businesses that, together with their associate entities have debt deductions of $2 million or less for an income year
- authorised deposit-taking institutions (ADIs)
- securitisation vehicles
- certain special purpose entities
- Australian plantation forestry entities.

The 90% Australian assets threshold exemption test (also called the assets threshold test for thin capitalisation purposes) doesn't exempt businesses from the DDCR.

The exemption for private or domestic assets and non-debt liabilities also does not apply for the purposes of the DDCR.

Interaction with Thin Capitalisation

The DDCR applies before the other thin capitalisation rules in Division 820 of the ITAA 1997.

Work out whether the DDCR disallows any debt deductions first. To the extent that any debt deduction is disallowed, it is ignored when applying the other thin capitalisation rules in Division 820 of the ITAA 1997.

The remaining debt deductions may then be further disallowed by those rules.

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