How the rules work

How thin capitalisation rules apply to different entities and the 3 tests that apply to general class investors.

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Financial entity

How the rules work for financial entities (non-ADI).

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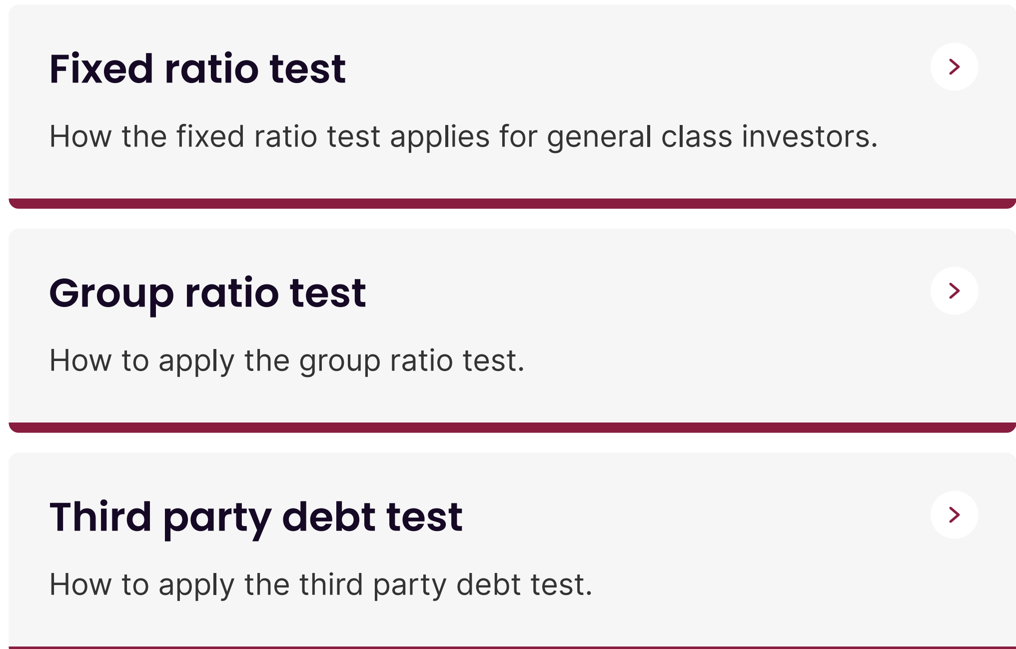
The concept of control is central when considering whether the thin capitalisation rules apply.

General class investors

A 'general class investor' is not a financial entity or an ADI but is subject to the thin capitalisation regime.

Modified definition of associate entity

Modified definitions of associate entity apply for the purposes of Subdivision 820-AA and 820-EAB of the ITAA 1997.



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How the rules apply

The thin capitalisation rules apply differently depending on the type of entity.

Last updated 24 July 2024

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Entity types

The thin capitalisation rules apply differently depending on whether an entity is:

- a general class investor
- a financial entity (non-ADI)

- an **authorised deposit-taking institution** (ADI).

These categories determine which tests apply to determine whether the thin capitalisation rules will limit an entity's debt deductions for an income year.

If you breach the rules

If an entity breaches the thin capitalisation rules in an income year, a proportion of its debt deductions for that year are disallowed.

Under the fixed ratio test, debt deductions that are disallowed may be carried forward for up to 15 years to offset future taxable income, provided certain conditions are met.

The disallowance of a debt deduction under the thin capitalisation rules does not affect whether the recipient is subject to Australian tax on that amount, including withholding tax. Disallowed debt deductions are not included as part of the CGT cost base when calculating the net gain made in respect of a CGT event.

For more information on debt deductions disallowed by thin capitalisation rules, see **section 110-54** of the ITAA 1997.

If you consolidate

If entities choose to consolidate, the thin capitalisation rules apply to the head company of the consolidated group or MEC group.

Once consolidated, the thin capitalisation rules then apply to the group as though it were a single entity for the income year. Subject to certain conditions, the group can include wholly-owned resident companies, trusts and partnerships, and Australian bank branches of foreign banks.

There are additional special rules to deal with financing arrangements between associate entities that are not grouped.

For more information about grouping, see **Consolidated groups and MEC groups**.

Authorised deposit-taking institution

How the rules work for ADIs classified under the Banking Act 1959.

QC 48128

Authorised deposit-taking institution

How the rules work for ADIs classified under the Banking Act 1959.

Last updated 24 July 2024

Special rules apply to entities that are authorised deposit-taking institutions (ADIs) under the *Banking Act 1959*. Entities covered by these rules include Australian banks and foreign banks that carry on business in Australia through a permanent establishment – for example, a foreign bank branch.

Financial entities (non-ADI) that meet certain conditions can also choose to apply the ADI rules – see **Electing to use the ADI rules** for more information.

Provided certain conditions are satisfied, including where all the ADIs in the group are specialist credit card institutions, the head company of a consolidated or multiple entry consolidated group (MEC group) containing one or more ADIs is allowed to apply the thin capitalisation rules as if the group was a financial entity. For more information, see **Choice to treat specialist credit card institutions as financial entities and not ADIs.**

ADI outward investing entity and **ADI inward investing entity** explain how to apply the thin capitalisation rules to ADIs.

QC 48130

Financial entity

How the rules work for financial entities (non-ADI).

Last updated 20 March 2025

A financial entity is an entity other than an ADI that is any of the following:

- a registered corporation under the *Financial Sector (Collection of Data) Act 2001* that carries on a business of providing finance, but not predominantly for the purposes of providing finance directly or indirectly to, or on behalf of, the entity's associates and derives all or substantially all its profits from that business
- a financial services licensee under the *Corporations Act 2001* (or an entity that is exempt from the requirement to hold an Australian financial services license for relevant dealings) that carries on a business of dealing in securities or derivatives (but not with or on behalf of its associates)
- a **securitisation vehicle**.

Examples of financial entities include finance companies and securities dealers.

Choice of tests

For income years commencing on or after 1 July 2023, eligible financial entities may:

- utilise the **safe harbour** or **worldwide gearing tests**, or
- choose to apply the **third party debt test**.

The rules for financial entities recognise that these entities are primarily engaged in lending as a business and have different requirements for debt funding. For example, for financial entities, the 1.5:1 safe harbour ratio applies to their non-lending business while their lending and certain other financial businesses are allowed higher gearing levels.

The safe harbour debt limit for financial entities (non-ADI) is 15:1 on a debt-equity basis.

Certain financial entities can elect to apply the ADI rules. For more information on this election, see **Electing to use the ADI rules**.

QC 48131

Modified definition of associate entity

Modified definitions of associate entity apply for the purposes of Subdivision 820-AA and 820-EAB of the ITAA 1997.

Published 24 July 2024

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Deemed choice to use the third party debt test

Modified definitions of 'associate entity' apply for specific purposes under Subdivision 820-AA of the ITAA 1997 (thin capitalisation rules for general class investors) and for the purposes of applying aspects of the third-party debt test under Subdivision 820-EAB of the ITAA 1997.

The standard definition of associate entity for thin capitalisation purposes is set out in section 820-905 of the ITAA 1997 and is covered in Terms we use. The modifications to this standard definition are set out below.

Fixed ratio test

When a general class investor is calculating its tax EBITDA, it is required to disregard certain amounts paid or distributed to it from associate entities. For these purposes, in determining whether an entity is an associate entity of another entity, the following modifications apply:

- The requirement in subsections 820-905(1) and (2A) of the ITAA 1997 that the entity is an associate of the other entity (under section 318 of the ITAA 1936) is disregarded, unless only paragraph 820-905(1)(b) of the ITAA 1997 applies.
- The references in paragraphs 820-905(1)(a) and 820-905(2A)(a) of the ITAA 1997 to “an associate interest of 50% or more” are treated as instead being a reference to “a TC control interest of 10% or more”. 'TC control interest' is defined in section 820-815 of the ITAA 1997.
- Subsection 820-860(3) of the ITAA 1997 is treated as applying for the purposes of determining whether the entity is an associate entity of the other entity.
- The purposes mentioned in subparagraphs 820-870(1)(b)(i) and (ii) of the ITAA 1997 are treated as including the purposes of determining whether the entity is an associate entity of the other entity.

Group ratio test

In determining whether an entity is an associate entity of another entity for the purposes of the group ratio test, the same modifications as outlined above in relation to the fixed ratio test apply, except that the references in paragraphs 820-905(1)(a) and 820-905(2A)(a) of the ITAA 1997 to “an associate interest of 50% or more” are treated as instead being a reference to “a TC control interest of 20% or more”. Refer to subsection 820-54(5) of the ITAA 1997 for further information.

Third party debt concepts

For the purposes of Subdivision 820-EAB of the ITAA 1997 (Third party debt concepts), in determining whether an entity is an associate entity of another entity the same modifications as outlined above in relation to the fixed ratio test apply, except that the references in paragraphs 820-905(1)(a) and 820-905(2A)(a) of the ITAA 1997 to “an associate interest of 50% or more” are treated as instead being:

- for the purposes of section 820-427A(5)(b) of the ITAA 1997, which concerns recourse against foreign associate entities – “a TC control interest of 50% or more”; and

- for any other purposes of any other provision in Subdivision 820-EAB of the ITAA 1997 – "a TC control interest of 20% or more".

Further, for the purposes of Subdivision 820-EAB of the ITAA 1997:

- an entity (the first entity) that has entered into a cross-staple arrangement with another entity is treated as an associate entity of that other entity
- if that other entity is itself an associate entity of a conduit financer — treat the first entity as an associate entity of the conduit financer.

Refer to section 820-427D of the ITAA 1997 for further information.

Deemed choice to use the third party debt test

In applying section 820-48 of the ITAA 1997 to determine whether an entity is deemed to have made a choice to apply the third party debt test the same modifications as outlined above in relation to the fixed ratio test apply, except that the references in paragraphs 820-905(1)(a) and 820-905(2A)(a) of the ITAA 1997 to "an associate interest of 50% or more" are treated as instead being a reference to "a TC control interest of 20% or more".

Note: An entity is also deemed to have made a choice to apply the third party debt test in relation to an income year if the entity has entered into a cross staple arrangement with one or more other entities and one or more of those entities have made a choice to apply the third party debt test in relation to that income year.

Table 1: TC control interest thresholds applicable to modified associate entity definitions

Relevant provisions	TC control interest threshold
Fixed ratio test – Calculation of tax EBITDA	10% or more Refer to fixed ratio test.
Group ratio test	20% or more

	Refer to **group ratio test**.
Third party debt concepts – Credit support rights covered by paragraph 820-427A(5)(b)	50% or more Refer to **third party debt test**.
Third party debt concepts – All other purposes	20% or more Refer to **third party debt test**.
Deemed choice to use third party debt test	20% or more Refer to **deemed choice to use third party debt test**.

QC 102760

Fixed ratio test

How the fixed ratio test applies for general class investors.

Published 24 July 2024

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How the fixed ratio test works

The fixed ratio test is the default test that applies for general class investors that do not make a choice to use either the group ratio test or the third party debt test.

If the fixed ratio test applies, the amount of debt deductions of an entity for an income year that is disallowed is the amount by which the entity's net debt deductions exceed the entity's fixed ratio earnings limit for the income year.

An entity's fixed ratio earnings limit for an income year is 30% of its tax EBITDA for that income year.

Net debt deductions

An entity's 'net debt deductions' for an income year are worked out according to the following steps:

Step 1: Work out the sum of the entity's debt deductions for the income year, less any debt deductions denied under the debt deduction creation rules in Subdivision 820-EAA of the ITAA 1997.

Step 2: Work out the sum of each amount included in the entity's assessable income for that year that is **one** of the following:

- either interest, an amount in the nature of interest, or any other amount economically equivalent to interest
- any amount directly incurred by another entity in obtaining or maintaining the financial benefits received by the other entity under a scheme giving rise to a debt interest
- any other expense that is incurred by another entity and that is specified in the regulations for the purposes of calculating net debt deductions under this step.

Step 3: Subtract the result of step 2 from the result of step 1.

The result of step 3 is the entity's net debt deductions for an income year. The entity's net debt deductions may be a negative amount.

Tax EBITDA

An entity's tax EBITDA for an income year is worked out according to the following steps:

Step 1: Work out the entity's taxable income or tax loss for the income year. In doing so disregard the operation of the thin capitalisation rules, except for the debt deduction creation rules in Subdivision 820-EAA of the ITAA 1997. Treat a tax loss for the income year as a negative amount. Certain adjustments are required to step 1.

Step 2: Add the entity's net debt deductions for the income year.

Step 3: Add the sum of the entity's deductions that are:

- decline in value and capital works deductions (if any) for the income year under Division 40 and Division 43 of the ITAA 1997. Do not include deductions available under these provisions if they represent the entire amount of an expense incurred by the entity (i.e. immediately deductible amounts).
- general deductions that relate to forestry establishment and preparation costs unless those costs relate to the clearing of native forests
- deductions for the capital costs of acquiring trees under section 70-120 of the ITAA 1997.

Step 4: Add the excess tax EBITDA amount for the income year (if any) (refer below for further information).

Step 5: Make adjustments in accordance with regulations (if any) made for the purposes of calculating the entity's tax EBITDA.

The result of step 5 is the entity's tax EBITDA for the income year. If the result of step 5 is less than zero, treat it as being zero.

Adjustments required for step 1

Amounts to be disregarded in calculating step 1

In calculating step 1 of an entity's tax EBITDA, the following amounts must be disregarded:

- Amounts that are included in the entity's assessable income under Division 207 of the ITAA 1997 (concerning franked distributions) to the extent that Division results in an amount of, or a share of, a franking credit being included in the entity's assessable income for the income year.
- Any dividend or non-share dividend paid to the entity by an associate entity and included in the entity's assessable income

under section 44 of the ITAA 1936. For this purpose, a modified definition of associate entity is set out in subsection 820-52(9) of the ITAA 1997.

- If the entity is a beneficiary of a trust other than an AMIT, and is an associate entity of the trust as defined in subsection 820-52(9) of the ITAA 1997, disregard
  - amounts included in the beneficiary's assessable income under Division 6 of Part III of the ITAA 1936, which deals with the net income of a trust
  - amounts included in the beneficiary's assessable income under Subdivision 115-C of the ITAA 1997, which deals with the grossing up of capital gains distributed by a trust to a beneficiary
  - distributions from the trust to the beneficiary.
- If the entity is a member of an AMIT, and is an associate entity of the AMIT as defined in subsection 820-52(9) of the ITAA 1997, disregard
  - amounts included in the member's assessable income under Division 276 of the ITAA 1997, which deals with the attribution of an AMIT's income and tax offsets to members of an AMIT
  - distributions from the AMIT.
- If the entity is a partner in a partnership and is an associate entity of the partnership (under subsection 820-52(9) of the ITAA 1997), disregard the entity's share of the net income of the partnership as determined under Division 5 of Part III of the ITAA 1936.

Application of step 1 to corporate tax entities

For the purposes of calculating step 1 of a corporate tax entity's tax EBITDA for an income year, assume that **both** the following apply:

- The entity chooses to deduct, under subsection 36-17(2) or (3), all of the entity's tax losses for loss years occurring before the income year.
- Subsection 36-17(5) of the ITAA 1997 does not apply to that choice.

Application of step 1 to trusts other than AMITs

In working out the tax EBITDA for an income year of a trust other than an AMIT, the reference to taxable income at step 1 is treated as being

a reference to the net income of the trust as determined under Division 6 of Part III of the ITAA 1936.

To avoid doubt, subsection 102UX(3) of the ITAA 1936 is disregarded in determining the net income of the trust for the purposes of calculating its tax EBITDA.

Application of step 1 to AMITs

In working out the tax EBITDA for an income year of an entity that is an AMIT, treat the reference to taxable income at step 1 as a reference to the net income of the entity as determined by reference to the AMIT's total assessable income for the income year reduced by all the deductions of the AMIT for the income year.

Application of step 1 to partnerships

In working out the tax EBITDA for an income year of a partnership, treat the reference to taxable income at step 1 as being a reference to the net income of the partnership as determined under Division 5 of Part III of the ITAA 1936.

Application of step 1 to R&D entities

In working out the taxable income or tax loss of an entity under step 1 of the tax EBITDA calculation, if the entity is an R&D entity that is entitled to a notional deduction for an income year under Division 355 of the ITAA 1997 in relation to R&D activities of the R&D entity, subtract an amount equivalent to the amount of the notional deduction.

Excess tax EBITDA amount

The tax EBITDA of a 'controlling entity' includes the 'excess' tax EBITDA of a 'controlled entity'.

Broadly, excess tax EBITDA amounts of a controlled entity are transferred to the controlling entity according to the controlling entity's average 'TC direct control interest' in the controlled entity for the income year. This requires a consideration of the direct control interest for each day of the income year. For a day to count towards the calculation of the average direct control interest, the direct control interest for that day must be 50% or greater.

An entity will be a controlling entity if it satisfies **all** the following conditions:

- It is one of the following entities for a period that is all or part of an income year
  - a company that is an 'Australian entity'
  - a unit trust that is a resident trust for CGT purposes
  - a managed investment trust that satisfies the residency requirement in subsection 275-10(3) of the ITAA 1997
  - a partnership that is an 'Australian entity'.
- The entity is a general class investor for all or part of the income year.
- The entity has not made a choice to apply the group ratio test or the third party debt test in relation to the income year.
- One or more other entities are a controlled entity in relation to the entity for the income year.

An entity (the 'test entity') will be a controlled entity in relation to a controlling entity if it satisfies **all** the following conditions:

- The controlling entity has a TC direct control interest of 50% or more in the test entity at any time during the income year.
- The test entity is one of the following entities for a period that is all or part of the income year
  - a company that is an Australian entity
  - a unit trust that is a resident trust for CGT purposes
  - a managed investment trust that satisfies the residency requirement in subsection 275-10(3) of the ITAA 1997
  - a partnership that is an 'Australian entity'.
- The test entity is a general class investor for all or part of the income year.
- The entity has not made a choice to apply the group ratio test or the third party debt test in relation to the income year.

The definition of Australian entity is contained in section 336 of the ITAA 1936. This definition is modified for partnerships under subsection 820-60(7) of the ITAA 1997. The modification ensures that for the purposes of determining an excess tax EBITDA amount, a

partnership will be an Australian entity where Australian residents and/or Australian trusts together hold at least a 50% direct participation interest in the partnership.

The following steps set out the calculation of the excess tax EBITDA amount that can be included in a controlling entity's tax EBITDA:

Step 1: For each controlled entity, work out the amount (if any) by which the fixed ratio earnings limit of the controlled entity for the income year exceeds the sum of the following:

- The controlled entity's net debt deductions for the income year (for this purpose, treat a negative amount of net debt deductions as nil).
- The total of the controlled entity's FRT disallowed amounts for the 15 income years ending immediately before the income year (to the extent those amounts have not been applied under section 820-56).

Step 2: For each controlled entity, you must apply **all** the following:

- Work out the controlling entity's TC direct control interest in the controlled entity for each day in the income year under the following provisions
  - subsection 820-60(4) of the ITAA 1997 for controlled entities that are companies
  - subsection 820-60(5) of the ITAA 1997 for controlled entities that are trusts
  - subsection 820-60(6) of the ITAA 1997 for controlled entities that are partnerships
- For each day on which the amount was 50% or greater, add the amounts calculated above.
- Divide the result above by the number of days in the income year during which the controlled entity was in existence. Express the result as a percentage.

Step 3: For each controlled entity, multiply the result of step 1 by the percentage worked out under step 2. If the amount worked out under step 1 for a controlled entity is nil, the result for that controlled entity under this step will be nil.

Step 4: Add up the amounts worked out under step 3.

Step 5: Divide the result of step 4 by 0.3. The result of this step is the excess tax EBITDA amount.

An excess tax EBITDA amount transferred to a controlling entity is taken into account when considering whether that controlling entity has an excess amount itself, which it can, in turn, transfer to another controlling entity.

Special deduction for fixed ratio test disallowed amounts

A special deduction allows general class investors to claim debt deductions that have been previously disallowed within the past 15 years under the fixed ratio test in a later income year.

For the special deduction to apply, the entity must be using the fixed ratio test for the income year and its fixed ratio earnings limit for the income year must exceed its net debt deductions. An amount of those previously disallowed debt deductions up to the excess amount may be able to be deducted, subject to satisfying further criteria. If net debt deductions are equal to or higher than the fixed ratio earnings limit, then no previously disallowed debt deductions can be deducted.

The amount of the deduction for an income year is worked out according to the following steps:

Step 1: Work out the amount by which the entity's fixed ratio earnings limit exceeds its net debt deductions for the current income year.

Step 2: Apply against that excess each of the entity's fixed ratio test disallowed amounts that arose in any of the previous 15 income years (to the extent that they have not already been applied under this step in a previous income year).

Step 3: The amount of the deduction is the total amount applied under step 2.

An entity has a 'fixed ratio test disallowed amount' for an income year equal to the debt deductions of the entity for the income year that are disallowed under the fixed ratio test for that income year.

Entities must have continually applied the fixed ratio test every income year to allow access to their balance of carried forward fixed ratio test disallowed amounts. However, the mere fact that Division 820 does

not apply to an entity in a subsequent income year will not result in fixed ratio test disallowed amounts being lost.

Fixed ratio test disallowed amounts must be applied in sequence, such that fixed ratio test disallowed amounts attributable to the earliest income year, subject to the 15-year limit, are applied first.

Loss rules for fixed ratio test disallowed amounts

If an entity is a company or trust, it must pass the company or trust loss rules in relation to its fixed ratio test disallowed amounts, otherwise the entity cannot apply the amount under step 2.

If an entity is a company, it must pass a modified version of the Continuity of Ownership Test (COT) or Business Continuity Test (BCT) in relation to each of its fixed ratio test disallowed amounts it wishes to apply under step 2.

Where the entity is a trust, it must pass a modified version of the trust loss rules in Schedule 2F to the ITAA 1936 in relation to each of its fixed ratio test disallowed amounts they are seeking to apply under step 2.

The special deduction and consolidated groups

Transferring a fixed ratio test disallowed amount

When an entity with a fixed ratio test disallowed amount joins a tax consolidated group, that fixed ratio test disallowed amount can be transferred to the head company of that group at the joining time, subject to certain conditions. This transfer occurs even where the joining entity becomes the head company of the tax consolidated group at the joining time.

The fixed ratio test disallowed amount is transferred only to the extent that the fixed ratio test disallowed amount could have been applied by the joining entity in respect of an income year (the trial year). The trial year is generally the period commencing 12 months before the joining time to just after the joining time.

Specifically, the fixed ratio test disallowed amount is transferred at the joining time from the joining entity to the head company if both:

- at the joining time, the joining entity had not become a member of the joined group (but had been a wholly owned subsidiary of the head company if the joining entity is not the head company)
- the amount applied by the joining entity under step 2 for calculating the special deduction for fixed ratio test disallowed amounts in respect of the trial year were not limited by the joining entity's excess amount under the preceding step 1.

If a fixed ratio test disallowed amount cannot be transferred, then the amount is effectively lost and cannot be applied under step 2 by any entity.

If a fixed ratio test disallowed amount is successfully transferred, then the head company is treated as having that amount for the same income year in which the joining entity had the amount. This preserves the effect of the 15-year limit for fixed ratio test disallowed amounts.

For the purposes of applying the modified COT, the head company is treated as acquiring fixed ratio test disallowed amounts at the joining time. This is necessary to ensure the modified COT is not automatically failed for income years occurring after consolidation. This is not a refresh of the 15-year utilisation period.

A head company may choose to cancel the transfer of fixed ratio test disallowed amounts that would otherwise be transferred by the joining entity. If the transfer is cancelled, the income tax law operates for the purposes of income years ending after the transfer as if the transfer had not occurred. That is, the loss cannot be utilised by any entity for those income years.

Impact on allocable cost amounts

When a tax consolidated group forms, or one or more entities join a tax consolidated group, tax costs for the assets of each joining entity are calculated by reference to the allocable cost amount (ACA) for the joining entity. On exit from the group, the process is reversed and the group's cost base of the equity in the leaving entity is derived from the net assets of the leaving entity at the designated time.

Step 6A of the ACA calculation requires taxpayers to subtract an amount in relation to fixed ratio test disallowed amounts transferred to the head company. The step 6A amount is generally worked out by

multiplying the sum of the transferred fixed ratio test disallowed amounts by the corporate tax rate.

In more limited circumstances, Step 5A of the ACA calculation requires taxpayers to subtract fixed ratio test disallowed amounts accruing to the joined group before the joining time, except to the extent that such an amount reduced the undistributed profits comprising the step 3 ACA amount.

Note: Where an entity's ACA includes a step 5A adjustment and it becomes a subsidiary member of a group at the same time as an interposed subsidiary member, the group will need to consider whether an adjustment is necessary to the market value of membership interests held by the interposed subsidiary member in other group members to determine the tax cost setting amount of the interposed subsidiary member's assets. Refer to section 705-160 of the ITAA 1997 for further information.

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Group ratio test

How to apply the group ratio test.

Published 24 July 2024

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>
> Meaning of audited consolidated financial statements
>
> Meaning of global financial statements

How the group ratio test works

An entity that is a general class investor for an income year may make a choice to apply the group ratio test in relation to that income year if it is a member of a GR group and the GR group EBITDA for the period is greater than zero.

For more information about how **general class investors** make a choice to apply a particular test, and the ordering of those choices, refer to **procedure of choices**.

As an alternative to the fixed ratio test, the group ratio test allows an entity in a sufficiently highly leveraged group to deduct more net debt deductions than the amount permitted under the fixed ratio rule, based on a ratio that relies on the group's financial statement.

A **modified definition of 'associate entity'** also applies for the purpose of the group ratio test.

Amount of debt deductions disallowed under the group ratio test

If a choice has been made to apply the group ratio test, the amount of debt deductions disallowed for an income year is the amount by which the entity's '**net debt deductions**' exceed the entity's group ratio earnings limit for the income year.

Calculating the group ratio earnings limit

- Step 1: Calculate your **tax EBITDA**.
- Step 2: Calculate your group ratio.
- Step 3: Multiply the result of step 2 by the result of step 1.

The calculation of an entity's tax EBITDA for the purposes of the group ratio test is determined in the same manner as that required for the **fixed ratio test**.

Group ratio

An entity's 'group ratio' for an income year is worked out according to the following steps:

Step 1: Work out the GR group net third party interest expense of the GR group.

Step 2: Work out the GR group EBITDA of the GR group.

Step 3: Divide the result of Step 1 by the result of Step 2. Subject to Step 4, the result of Step 3 is the entity's group ratio for the income year.

Step 4: If the result of Step 2 is zero, the entity's group ratio for the income year is zero.

GR Group net third party interest expense

The GR group net third party interest expense is the amount that would be the group's financial statement net third party interest expense if the following amounts are treated as interest:

- an amount in the nature of interest
- any other amount that is economically equivalent to interest.

Financial statement net third party interest expense

The financial statement net third party interest expense of a GR group for the period is the net third party interest expense – taken from either the audited consolidated financial statements or the global financial statements (depending on whether the parent entity is a worldwide parent entity or global parent entity respectively) – reduced by the amount of a payment that is:

- relevant to working out the net third party interest expense and made to an associate entity; and
- made to a payee (entity) that is either:
  - a member of the GR group and the associate entity is not
  - not a member of the GR group and the associate entity is.

GR group EBITDA

The GR group EBITDA is relevant to calculating the group ratio earnings limit. The GR group EBITDA for a period is the sum of the GR group's:

- net profit (disregarding tax expenses)
- adjusted net third party interest expense
- depreciation and amortisation expenses.

If a GR group member has an entity EBITDA less than zero, disregard that entity EBITDA in calculating the GR group EBITDA.

The entity EBITDA of an entity, for a period, is the sum of the entity's:

- net profit (disregarding tax expenses)
- adjusted net third party interest expense
- depreciation and amortisation expenses.

Adjusted net third party interest expense

The adjusted net third party interest expense is relevant in calculating the GR group EBITDA or an individual entity EBITDA. It is equal to the net third party interest expense of the GR group or entity, disregarding the following payments for:

- an entity, a payment that is made by
  - the entity to an associate entity of the entity
  - an associate entity of the entity to the entity
- a GR group, a payment that is made by
  - a GR group member of the GR group to an associate entity of any GR group member of the GR group
  - an associate entity of a GR group member of the GR group to any GR group member of the GR group.

In disregarding certain payments between associates, the adjusted net third party interest expense should only reflect amounts paid to third parties.

Meaning of GR group, GR group member and GR group parent

A GR group and GR group members are determined by reference to the composition of an accounting consolidated group that reports in audited consolidated financial statements or global financial statements.

If ‘audited consolidated financial statements’ have been prepared for a ‘worldwide parent entity’ for a period, the GR Group for that period will comprise of both:

- the worldwide parent entity
- each other entity that is fully consolidated on a line-by-line basis in those audited consolidated financial statements.

Each of the above entities is a GR group member for that period. The worldwide parent entity for the period is the GR group parent for the period.

An entity is a worldwide parent entity if the audited consolidated financial statements have been prepared in relation to that entity and, for the purposes of the standards in accordance with which the statements were prepared, the entity is not controlled by another entity.

If audited consolidated financial statements have not been prepared and 'global financial statements' have been prepared for a ‘global parent entity’ for a period, the GR Group for that period will comprise of both:

- the global parent entity
- each other entity that is fully consolidated on a line-by-line basis in those global financial statements.

Each of the above entities is a GR group member for that period. The global parent entity for the period is the GR Group parent for the period.

A global parent entity is an entity that is not controlled by another entity under accounting standards developed by the Australian Accounting Standards Board or otherwise in accordance with commercially accepted principles relating to accounting.

Meaning of audited consolidated financial statements

Financial statements will meet the definition of audited consolidated financial statements if they meet the following requirements:

- The statements have been prepared on a consolidated basis in relation to the entity and one or more other entities in accordance with either
  - recognised overseas accounting standards in the following foreign jurisdictions
    - the European Union
    - the United Kingdom
    - the United States of America
    - Canada
    - Japan
    - New Zealand
    - any other jurisdiction specified in a legislative instrument.
  - international financial reporting standards that are made or adopted by the International Accounting Standards Board.
- The statements have been audited in accordance with the law applicable either in the foreign jurisdictions noted above or another jurisdiction that has adopted international financial reporting standards adopted by the International Accounting Standards Board.
- One of the entities is a worldwide parent entity. An entity is a worldwide parent entity if the financial statements have been prepared in relation to that entity and, for the purposes of the standards in accordance with which the statements were prepared, the entity is not controlled by another entity.
- The statements are for the most recent period, ending no later than the end of the relevant period and no earlier than 12 months before the start of the relevant period.
- The statements show amounts relating to statement worldwide debt, statement worldwide equity and statement worldwide assets

(as defined in section 820-933), however described, on a consolidated basis.

Meaning of global financial statements

Global financial statements for an entity for a period are financial statements that:

- have been prepared in accordance with accounting standards or other applicable authoritative pronouncements developed by the Australian Accounting Standards Board
- have been audited in accordance with auditing standards or other applicable authoritative pronouncements developed by the Auditing and Assurance Standards Board
- are for the most recent period ending no later than the end of the relevant period and no earlier than 12 months before the start of the relevant period.

If financial statements have not been prepared in accordance with the accounting standards and auditing standards referred to above, they can otherwise be prepared in accordance with commercially accepted principles relating to accounting and auditing that ensure that the statements give a true and fair view of the financial performance and position of the entity or that entity and the other entities on a consolidated basis.

For more information, see **section 960-570** of the ITAA 1997.

QC 102762

Third party debt test

How to apply the third party debt test.

Last updated 24 July 2024

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What is the third party debt test

The 'third party debt test', is an elective test that supplements the earnings-based tests.

Under the third party debt test, the amount of the debt deductions of an entity for an income year that is disallowed is the amount by which the entity's debt deductions exceed the entity's third party earnings limit for the income year.

An entity's third party earnings limit for an income year is the sum of each debt deduction of the entity for the income year that is attributable to a debt interest that satisfies the third party debt conditions in relation to the income year. Broadly speaking, a debt interest only satisfies the third party debt conditions if it is issued to and held by an unrelated third-party and certain other conditions are met.

If an amount is disallowed under the third party debt test, then (as with all other tests) each individual debt deduction is disallowed in the same proportion that the total disallowed amount represents to the total debt deductions of the entity for the income year.

The third party debt test is designed to be narrow, to accommodate only genuine commercial arrangements relating only to Australian business operations. It is not intended to accommodate all debt financing arrangements that may be accepted as current practice within industry.

Who can make a choice to apply the third party debt test

General class investors and financial entities can choose to apply the third party debt test. A choice to use the third party debt test for an

income year must be made:

- in the approved form
- on or before the earlier of the following days
  - the day the entity lodges its income tax return for the income year
  - the day the entity is required to lodge its income tax return for the income year
  - a later day allowed by the Commissioner.

Some general class investors are deemed to have made a choice to apply the third party debt test. To determine if you are deemed to have made a choice to apply the third party debt test, refer to **Deemed choice to use the third party debt test**.

If an entity is taken to have made a choice to use the third party debt test for an income year, then that entity cannot make a choice to use the group ratio test, and any existing choice to use the group ratio test in relation to that income year is automatically revoked and taken to never have been made.

Third party earnings limit

The amount of an entity's debt deductions for the income year that is disallowed under the third party debt test is the amount by which the entity's debt deductions exceed the entity's third party earnings limit for the income year.

An entity's 'third party earnings limit' is the sum of each deduction of the entity that is attributable to a debt interest issued by the entity that satisfies the third party debt conditions in relation to the income year.

Specific adjustments have been included for hedging arrangements. For these purposes, debt deductions of an entity are taken to be attributable to the debt interest if they are both:

- directly associated with hedging or managing the interest rate risk in respect of the debt interest
- not referrable to an amount paid, directly or indirectly, to an associate entity of the entity.

This rule is intended to only cover conventional 'interest rate swap' arrangements between unrelated parties.

Third party debt conditions

A debt interest issued by an entity satisfies the ‘third party debt conditions in relation to an income year if the following conditions are satisfied:

- The entity is an Australian entity.
- The entity issued the debt interest to an entity that is not an associate entity of the entity.
- The debt interest is not held at any time in the income year by an entity that is an associate entity of the entity.
- Disregarding recourse to minor or insignificant assets, the holder of the debt interest has recourse for payment of the debt to which the debt interest relates only to
  - Australian assets held by the entity that issued the debt interest, or
  - Australian assets of another Australian entity that is the member of the obligor group in relation to the debt interest, or
  - membership interests in the entity that issued the debt interest (unless the entity has a legal or equitable interest, directly or indirectly, in an asset that is not an Australian asset).

For the purposes of this condition, Australian assets that are rights under or in relation to a guarantee, security or other form of credit support, are generally excluded unless otherwise specified.

- the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia but not:
  - any business carried on through an overseas permanent establishment, or
  - holding any associate entity debt, controlled foreign entity debt or controlled foreign entity equity

For the purposes of third party debt conditions:

- a modified definition of 'associate entity' is used which is based on a thin capitalisation control interest of 20% or more, unless otherwise specified
- an entity that has entered into a cross-staple arrangement with another entity is treated as an associate entity of that other entity and any conduit financier that other entity is itself an associate entity of.

Recourse to Australian assets

Generally, recourse available to the holder of the debt interest cannot extend beyond the Australian assets held by the issuer of the debt interest, membership interests in the borrower and Australian assets of other Australian entities that are members of the obligor group in relation to the debt interest. In substance, this requires that Australian borrowers support their third party debt levels with Australian assets of Australian entities in order to include all debt deductions related to that debt in its third party earnings limit. This complements the requirements for the funds to be used in Australian commercial activities.

In most circumstances where the Australian borrower's associated foreign entities (such as global parent entities or offshore treasury entities) provide recourse to a lender to assets other than membership interests in the borrower, no debt deductions related to that borrowing will be included in the third party earnings limit.

The general prohibition on recourse to credit support rights

Under the third party debt conditions, recourse to Australian assets that are rights under or in relation to a guarantee, security or other form of credit support is generally prohibited unless the right is any of the following:

- a right that provides recourse, directly or indirectly, only to one or more Australian assets of the borrower or another member of the obligor groups (unless those rights are otherwise prohibited)
- a right that would not be expected to allow the lender or another entity to have recourse for payment of the debt against an associate entity of the entity that issued the tested debt interest

- a right that relates wholly to the creation or development of a CGT asset that is (or is reasonably expected to be) either
  - land situated in Australia (including an interest in land, if the land is situated in Australia)
  - moveable property situated, or to be situated, on land situated in Australia, and that is (or is reasonably expected to be) relevant to the income producing use of the land and situated on the land for the majority of its useful life
  - offshore renewable energy infrastructure (within the meaning of the *Offshore Electricity Infrastructure Act 2021*) situated, or to be situated, in a declared area (within the meaning of that Act) for the majority of its useful life
  - offshore electricity transmission infrastructure (within the meaning of the *Offshore Electricity Infrastructure Act 2021*) that is directly related to offshore renewable energy infrastructure meeting the above criteria.

For the purposes of determining whether a right relates wholly to the creation or development of a CGT asset, disregard the extent (if any) to which the right relates incidentally to another matter.

Conduit financing conditions

Additional rules allow for 'conduit financer' arrangements to satisfy the third party debt conditions in certain circumstances. Such arrangements are generally implemented to allow one entity in a group to raise funds on behalf of other entities in the group. This can streamline and simplify borrowing processes for the group. However, debt interests issued under such arrangements ordinarily would not satisfy the third party debt conditions.

In the context of the third party debt test, conduit financer arrangements exist where an entity (the 'conduit financer') issues a debt interest (the 'ultimate debt interest') to another entity that is not an associate entity (the 'ultimate lender'). The conduit financer then on-lends the proceeds of the ultimate debt interest to one or more associate entities (each a 'borrower', and each on-loan being a

'relevant debt interest') on largely the same terms as the ultimate debt interest.

The 'conduit financing conditions', and the modifications to the third party debt conditions under section 820-427B of the ITAA 1997 that apply when the conduit financing conditions are satisfied, are designed to enable both the relevant debt interest and the ultimate debt interest to satisfy the third party debt conditions in these types of conduit financing scenarios, provided certain conditions are met.

Relevant debt interest which satisfies the conduit conditions.

A relevant debt interest satisfies the conduit financing conditions in relation to an income year if:

- the conduit financer issues a debt interest (the 'ultimate debt interest') to an entity (the ‘ultimate lender’) that is not an associate entity of the conduit financer
- an entity that is an associate entity of the conduit financier (the 'borrower') issues a debt interest (the 'relevant debt interest') to the conduit financer
- the amount loaned under the relevant debt interest was financed by the conduit financer only with proceeds from of the ultimate debt interest
- the terms of the relevant debt interest, to the extent those terms relate to a cost incurred by the borrower in relation to the relevant debt interest, are the same as the terms of the ultimate debt interest, to the extent those terms relate to such costs incurred by the conduit financer in relation to the ultimate debt interest (the 'same terms' requirement). However, for these purposes, the following terms are disregarded
    - terms of a debt interest to the extent that those terms relate to the amount of the debt
    - terms of the ultimate debt interest that have the effect of allowing the recovery of reasonable administrative costs of the ultimate lender that relate directly to the ultimate debt interest
    - terms of a relevant debt interest issued to the conduit financer that have the effect of allowing the recovery of reasonable

administrative costs of the conduit financer that relate directly to the relevant debt interest
  - terms of a relevant debt interest that have the effect of allowing the recovery of costs of the conduit financer that are a debt deduction of the conduit financer and are treated as being attributable to the ultimate debt interest under subsection 820-427A(2) of the ITAA 1997 (concerning interest rate swap arrangements)
  - terms of a relevant debt interest that have the effect of allowing the recovery of costs of a borrower that are a debt deduction of the borrower and are treated as being attributable to another debt interest under subsection 820-427A(2) of the ITAA 1997.
- the conduit financer and the borrower are Australian entities
- the conduit financer and the borrower apply the third party debt test.

Modified definition of ‘associate entity’

A modified definition of ‘associate entity’ also applies for the purpose of the third party debt test. In determining whether an entity is an associate entity of another entity, disregard the requirement in subsections 820-905(1) and (2A) that the entity is an 'associate' of the other entity (unless only paragraph 820-905(1)(b) applies) and the references to 'an associate interest of 50% or more' are treated as:

- for the purposes of paragraph 820-427A(5)(b) — a reference to a TC control interest of 50% or more
- for the purposes of any other provision within the third party debt test method — a reference to a TC control interest of 20% or more
- Subsection 820-860(3) is treated as applying for the purposes of determining whether the entity is an associate entity of the other entity.

For more information, see **modified associate entity definition**.

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