18 May 2026

The Secretariat
The Board of Taxation

Via email: taxboard@taxboard.gov.au

Dear Secretariat,

Statutory Review of Australia's Thin Capitalisation Reforms

The Australian Financial Markets Association (**AFMA**) represents the interests of over 130 participants in Australia's financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. AFMA's members are the major providers of wholesale banking and financial market services to Australian businesses and investors. A significant proportion of AFMA's members are Approved Deposit-Taking Institutions (ADIs) for thin capitalisation purposes.

We are pleased to contribute to the Board's review of the thin capitalisation reforms. AFMA notes that these reforms encompass the new debt deduction creation rules, the amended definition of "financial entity" and the amended definition of "debt deduction."

Executive Summary

AFMA makes the following recommendations, by way of executive summary:

- The Board should recommend that the debt deduction creation rules be narrowed so as to operate in accordance with their intended scope, and that financial entities be carved-out from the rules;
- That the Board recommend amendments to the definition of "financial entity" to reduce the compliance costs and risks for entities that are clearly financial in nature. This may include that all holders of Australian Financial Services Licences (AFSL) are considered to be "financial" for thin capitalisation purposes;
- That the Board recommend exceptions from the expanded definition of "debt deduction" for ADIs, financial entities and securitisation vehicles given the current application to instruments that are entered into for trading/hedging purposes and have no nexus to debt.

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

Debt Deduction Creation Rules

For those AFMA members that operate in Australia through an ADI, or have an ADI in their group, the debt deduction creation rules have no application. However, for those members that operate institutional financial businesses in Australia, the debt deduction rules do apply and create significant compliance costs and exacerbate risk in a manner that is disproportionate to the policy intent of the rules.

As the Board is aware, the legislation to give rise to the debt deduction creation rules was introduced into Parliament without meaningful consultation with industry. The result was legislation that is, at best, not fit for purpose and, at worst, completely unworkable. The tracing requirements in the rules are incompatible with the way that international finance operates and the structure of global businesses that undertake cross-border transactions with related parties.

AFMA's significant concerns with the debt deduction creation rules are as follows:

- The provisions appear to apply to deny debt deductions even in circumstances where there is no increase in the overall debt held in Australia. The rules apply to rationalisation of domestic businesses, where the debt in the aggregated entity is the same or even less than the debt of the segregated entities, which appears counterintuitive;
- Routine securities transactions such as securities lending arrangements and repo transactions are in scope from the proposed provisions, thereby disrupting the efficient operation of capital markets;
- Vanilla financing transactions where a bank raises funds in a certain jurisdiction to access capital markets and then on-lends those funds to the jurisdictions where business is undertaken, which is a routine transaction for any financial entity, are caught by the second limb, such that the rules are a significant obstacle to the efficient operation of funding markets;
- Routine restructuring/rationalisation transactions and working capital arrangements are within scope of the operation of the proposed rules;
- In circumstances where related party debt is on-lent to an associate, the interest income will be assessable while the interest expense will be non-deductible, resulting in significant asymmetry.

AFMA notes that the amendments to the thin capitalisation rules were designed to apply to general entities; however, given the scope of the carve-out is in relation to ADI entities only, financial entities are within scope of the operation of the rules. Accordingly, AFMA recommends;

- That the Board recommend amendments to the debt deduction creation rules to narrow their scope and operate as intended; or
- That the Board recommends that financial entities be carved out from the debt deduction creation rules.

Definition of "Financial Entity"

The thin capitalisation amendments included changes to the definition of "financial entity." These amendments have generated significant risk and burden for affected entities, with

entities that would routinely be considered to be "financial" needing to undertake significant analysis, including senior legal opinion, to justify the approach adopted.

In AFMA's view, Australian entities which have an AFSL but are not ADIs should be considered "financial entities" under the derivatives definition if such Australian entities in their standard course of business transact with affiliates offshore as part of the global trading business to support their businesses in Australia, which principally involves facilitating client transactions. This includes executing client transactions, market making, acting as principal to assist clients in managing their risk, and hedging risk. Securities are pooled across multiple jurisdictions. Dealing with affiliates offshore (such as entering derivatives) is integral for Australian entities to conduct their businesses in line with the business model to manage risks (e.g. by entering into various hedging agreements with other parties which reduces or eliminates its exposures).

Adopting this approach would create a "bright-line" test that removes current ambiguity and uncertainty. In AFMA's view, causing entities that are clearly financial in nature to spend ridiculous amounts of time and resources to demonstrate that they adhere to the updated definition is completely unproductive, with a likely behavioural response for such firms being to undertake activities currently being done in Australia in other jurisdictions, thereby undermining Australia's aspiration as a regional financial centre.

Definition of Debt Deduction

The thin capitalisation amendments expand the definition of "debt deduction" to include amounts which are economically equivalent to interest. While these amendments may be appropriate for general class entities for thin capitalisation purposes, AFMA remains concerned that the expanded definition gives rise to unintended consequences for banks or other entities that enter into derivative transactions for purposes entirely unrelated to debt, such as for trading or hedging purposes. By removing the nexus between the deduction and a debt interest issued by the entity, our concern is that deductions on losses arising from circumstances entirely unrelated to a debt interest could be caught within the expanded definition of "debt deduction."

The amendments remove the requirement for a nexus between the debt deduction and a debt interest issued by the entity and replace "calculated by reference to the time value of money" with "economically equivalent to interest." In addition, the definition excludes "losses and outgoings directly associated with hedging or managing the financial risk in respect of the debt interest." On this reading, it is tenable that all flows under interest rate derivatives could be included in the definition of a "debt deduction." This is the current view of the ATO, which has acknowledged that such a position is inconsistent with the policy intent.

Additionally, there does not appear to be a concept of "net debt deduction" in the expanded definition. Generally, banks and other financial entities will look to hedge exposures on a portfolio basis and under the Taxation of Financial Arrangements (TOFA) provisions in Division 230, there is no requirement for such taxpayers to "gross out" gains and losses on individual positions. As such, to the extent that the definition of "debt deduction" is expanded to include payments on interest rate swaps without the nexus to a debt interest, this would significantly exacerbate not only compliance costs but also the quantum of disallowance in a manner entirely disproportionate to what could be considered to be economically equivalent to a cost of debt.

In our view, the Board should recommend that the expanded definition of “debt deduction” should not apply to ADIs, securitisation vehicles or financial entities. This would reduce the risk of significant unintended consequences for financing entities and be consistent with the general approach of the Bill, namely, to amend the thin capitalisation arrangements for general entities only.

* * * * *

Please contact me on (02) 9776 7996 or at rcolquhoun@afma.com.au to discuss any of the matters that we have raised in this submission.

Yours sincerely,

Rob Colquhoun
Head of Tax