Inward investing entity (ADI)

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

Step 1: Calculate the average equity capital

How to calculate the average equity capital if you're an inward investing entity (ADI).

Step 2: Calculate the safe harbour capital amount

How to calculate the safe harbour capital amount if you're an ADI inwards investing entity.

Step 3: Calculate the arm's length capital amount

How to calculate the arm's length capital amount if you're an inward investing entity (ADI).

Step 4: Calculate the debt deductions disallowed

How to calculate the debt deductions disallowed if you're an inward investing entity (ADI).

QC 48171

Step 1: Calculate the average equity capital

How to calculate the average equity capital if you're an inward investing entity (ADI).

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Before you start – record keeping

An inward investing entity (ADI) carrying on business at or through a permanent establishment with total revenues attributable to that permanent establishment of at least $2 million are subject to certain record keeping requirements. These requirements are financial statements, including all the necessary notes. They must be prepared for its Australian permanent establishment using the Australian accounting standards or the accounting standards of Germany, Japan, France, USA, UK, Canada, New Zealand or the international accounting standards.

Step 1

Broadly, the average equity capital of an inward investing entity (ADI) is the equity capital allocated to its Australian operations.

Table 34: Inward investing entity (ADI)'s step 1 and *Worksheet 28: Inward investing entity (ADI)'s step 1* explain how an inward investing entity (ADI) calculates its average equity capital.

For more information, see **subsection 820-395(3)** of the ITAA 1997.

Table 34: Inward investing entity (ADI)'s step 1

Steps	Comments
Step 1.1: Calculate the average value, for the income year, of all the ADI's	ADI equity capital is the total value of the ADI's equity capital

equity capital attributable to its Australian permanent establishments through which it carries on its banking business in Australia that has not been allocated to the offshore banking activities of those Australian permanent establishments. Insert this amount at **A** on *Worksheet 28: inward investing entity (ADI)'s step 1*.	plus certain, long-term debt interests. Disregard any equity capital allocated to any of the Australian permanent establishments' offshore banking activities – see **section 121D** of the ITAA 1936.
Step 1.2: Calculate the average value, for that year, of all the amounts the ADI has lent to its Australian permanent establishments through which it carries on its banking business in Australia that do not give rise to any debt deductions for the ADI in that year or any other income year. Insert this amount at **B** on *Worksheet 28: inward investing entity (ADI)'s step 1*.	ADI equity capital is increased by amounts the ADI has made available as loans to its Australian permanent establishments through which it carries on a banking business in Australia, if these amounts do not give rise to any debt deductions for the ADI in that or any other income year; that is, dotation capital.
Step 1.3: Calculate the average equity capital by adding the amounts at **A** and **B.**	Average equity capital represents the ADI equity capital attributable to the Australian permanent establishments (**A**), plus any debt deduction free amounts made available to the Australian permanent establishments (**B**).

Worksheet 28: Inward investing entity (ADI)'s step 1

Steps	$
Step 1.1: Average ADI equity capital attributable to the Australian permanent	(**A**) ______

establishments through which it carries on its banking business in Australia	
Step 1.2: Average debt deduction free amounts made available to the Australian permanent establishments through which it carries on its banking business in Australia	(**B**) ____________
Step 1.3: Average equity capital (**A** + **B**)	= ____________

Compare this to the ADI's minimum capital amount, which is the lesser of the safe harbour capital amount (**step 2**) and the arm's length capital amount (**step 3**).

For more information, see **Worked example of calculations for an inward investing entity (ADI)**.

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Step 2: Calculate the safe harbour capital amount

How to calculate the safe harbour capital amount if you're an ADI inwards investing entity.

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The safe harbour capital amount is a level of equity capital that an ADI must allocate to its Australian operations. This amount is based on the value of net risk-weighted assets attributable to the Australian operations. The safe harbour capital amount is broadly based on the methodology of the capital adequacy requirements prescribed by prudential regulators, for example, Australian Prudential Regulation Authority (APRA).

Table 35: Inward investing entity (ADI)'s step 2 and *Worksheet 29: Inward investing entity (ADI)'s step 2* explains how to work out the safe harbour capital amount.

For more information, see **section 820-405** of the ITAA 1997.

Note: You will need a copy of the prudential standards to work out the safe harbour capital amount.

Table 35: Inward investing entity (ADI)'s step 2

Steps	Comments
Step 2.1: Calculate the average value, for the income year, of all the ADI's net risk-weighted assets that are: • attributable to the ADI's Australian permanent establishments through which it carries on its banking business in Australia • not attributable to those Australian permanent establishment's offshore banking activities. Insert this amount at **C** on *Worksheet 29: Inward investing entity (ADI)'s step 2.*	The first step is to work out the average value of the ADI's net risk-weighted assets attributable to its Australian operations. The risk-weighted assets are its risk exposures determined in accordance with either the Australian prudential standards or the prudential standards of the foreign country in which the ADI is a resident.
Step 2.2: Calculate the safe harbour capital amount by multiplying the amount at **C** by 6%.	The safe harbour capital amount represents 6% of the average risk-weighted assets attributable to the Australian banking permanent establishments.

Worksheet 29: Inward investing entity (ADI)'s step 2

Steps	$
Step 2.1: Average risk-weighted assets attributable to the Australian banking permanent establishments	(**C**) ____________
Step 2.2: Safe harbour capital amount (**C** × **6%**)	= ______________

If the ADI's average equity capital is equal to or more than the safe harbour capital amount, the ADI is not disallowed any debt deductions under the thin capitalisation rules. You do not have to complete any more calculations.

If the ADI's average equity capital is less than the safe harbour capital amount, you can choose to calculate an arm's length capital amount (see **step 3**) or you can use your safe harbour capital amount as the minimum capital amount and debt deductions will be disallowed on this basis (**step 4**).

For more information, see **Worked example of calculations for an inward investing entity (ADI)**.

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Step 3: Calculate the arm's length capital amount

How to calculate the arm's length capital amount if you're an inward investing entity (ADI).

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How to apply step 3

If the ADI's average equity capital is less than its safe harbour capital amount, it can choose to adopt an arm's length capital amount as its minimum capital amount. It would generally do so only if the arm's length capital amount is less than the safe harbour capital amount.

The arm's length capital test focuses on the ADI's Australian business. The arm's length capital amount is determined by conducting an analysis about certain factual assumptions and relevant factors. The factual assumptions include some conditions that exist during the income year and some conditions that replace what happened during that period.

The result of the analysis is a notional amount of capital that represents what would reasonably be expected to have been the ADI's minimum capital amount throughout the year in relation to its

Australian business. The Australian business is treated as if it were a separate entity – independent and operating at arm's length from the other parts of the ADI.

Broadly, the assumptions are that the ADI's:

- commercial activities are those of its Australian business – Australian business has a wide meaning
- Australian business was independent of any guarantee, security or other support provided by any of the entity's associates or using the assets that are attributable to the entity's overseas permanent establishments.

Relevant factors

Certain factors, outlined below, must be considered when doing the analysis. All the factors must be considered and must be considered in the context of the above assumptions. The factors should not be considered in isolation from each other. The weight given to each factor in analysing a particular ADI may vary, depending on the facts and circumstances of each case.

The factors are:

- the functions performed, the assets used and the risks assumed in relation to the ADI and its Australian business throughout the year
- the ADI's credit rating and the effect of that rating on the ADI's ability to borrow in relation to its Australian business, the interest rate of such a borrowing and the gross profit margin in relation to that business
- the capital ratios of the ADI, the ADI's Australian business and the ADI's associate entities that engage in commercial activities similar to the Australian business of the ADI
- the ADI's purpose of entering the loan arrangements in relation to itself and its Australian business throughout the year
- the profitability of the ADI and the ADI in relation to its Australian business
- commercial practices adopted by independent parties dealing with each other at arm's length in the industry in which the ADI operated

its Australian business throughout the year, whether in Australia or in comparable markets elsewhere

- the general state of the Australian economy throughout the year
- any other relevant factors that must be considered as set out in the regulations made for the purposes of the arm's length capital amount test.

If an ADI is relying on an arm's length capital amount, it must keep records documenting the application of the factual assumptions and relevant factors. These records must be prepared before the entity lodges its tax return.

If the ADI has not appropriately considered the factual assumptions and the relevant factors to calculate the arm's length amount, we have the power to substitute a different arm's length amount that we consider to better reflect those assumptions and relevant factors.

For more information, see **section 820-410** of the ITAA 1997.

Once you have worked out the ADI's arm's length capital amount, compare it to the ADI's average equity capital.

If the ADI's average equity capital is equal to or more than the arm's length capital amount, the ADI is not disallowed any debt deductions under the thin capitalisation rules. You do not have to complete any more calculations.

If the ADI's average equity capital is less than its arm's length capital amount and its safe harbour capital amount, you must complete **step 4**.

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Step 4: Calculate the debt deductions disallowed

How to calculate the debt deductions disallowed if you're an inward investing entity (ADI).

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The ADI's minimum capital amount is the lesser of the:

- safe harbour capital amount from step 2
- arm's length capital amount from step 3.

You do not necessarily have to calculate both amounts. If you do not want to calculate an arm's length capital amount you can use the safe harbour capital amount as the minimum capital amount.

If the ADI's average equity capital is less than its minimum capital amount, a proportion of its debt deductions cannot be deducted. *Table 36: Inward investing entity (ADI)'s step 4* and *Worksheet 30: Inward investing entity (ADI)'s step 4* work out the proportion disallowed.

For more information, see **section 820-415** of the ITAA 1997.

Table 36: Inward investing entity (ADI)'s step 4

Steps	Comments
Step 4.1: Calculate the amount by which the ADI's average equity capital is less than its minimum capital amount; that is, the capital shortfall. Insert the result at **D** on the *Worksheet 30: Inward investing entity (ADI)'s step 4*.	The proportion of debt deductions disallowed depends on the amount by which the ADI's average equity capital (from step 1) is less than its minimum capital amount.
Step 4.2: Calculate the ADI's average debt. Insert this amount at **E** on *Worksheet 30: Inward investing entity (ADI)'s step 4*.	The average debt is the average value, for the income year, of the ADI's debt capital that gives rise to debt deductions (in Australia) in that year or any other income year. However, it does not include debt that gives rise to allowable off-shore banking deductions.
Step 4.3: Divide the amount at **D** by the amount at **E.** Insert the result at **F** on *Worksheet 30: Inward*	This step works out what proportion to apply to the ADI's debt deductions to calculate the amount disallowed.

investing entity (ADI)'s step 4.	
Step 4.4: Calculate the amount of debt deductions for the income year. Insert this amount at **G** on *Worksheet 30: Inward investing entity (ADI)'s step 4.*	The calculation is applied to all the ADI's debt deductions for the year, other than allowable off-shore banking deductions.
Step 4.5: Multiply the amount at **F** by the amount at **G**. This is the amount of debt deductions disallowed.	This calculates the amount of debt deduction disallowed. The debt deductions that would be allowed, but for thin capitalisation, are each reduced proportionately.

Worksheet 30: Inward investing entity (ADI)'s step 4

Steps	$
Step 4.1: Capital shortfall (minimum capital amount minus average equity capital)	(**D**) ______________
Step 4.2: Average debt	(**E**) ______________
Step 4.3: D ÷ E	(**F**) ______________
Step 4.4: Debt deductions for the income year	(**G**) ______________
Step 4.5: F × G This is the total debt deductions disallowed.	= ______________

For more information, see **Worked example of calculations for an inward investing entity (ADI)**.

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