Thin capitalisation and consolidated groups

Note

MEC groups and the thin capitalisation rules

The thin capitalisation rules for consolidated groups also apply to multiple entry consolidated (MEC) groups. For the purposes of this section, 'consolidated groups' includes MEC groups.

Repeal of thin capitalisation grouping rules

The thin capitalisation grouping rules generally cease to operate for a company from the time it becomes a member of a consolidated group or from 1 July 2003, whichever is earlier. However, these rules continue to operate until the consolidation day (joining time) for companies that become members of a consolidated group that forms on the first day of the head company's income year beginning before 1 July 2004. The day on which the thin capitalisation rules cease to operate is referred to as the 'cut-off day'[1].

The thin capitalisation grouping rules are effectively replaced by the consolidation rules. The consolidation rules determine which entities form part of the head company's group for income tax purposes; the thin capitalisation provisions then apply to the head company of a consolidated group in accordance with the single entity principle. This means the head company, together with the subsidiary members of the group, are treated as a single entity for the purposes of applying the thin capitalisation provisions. The thin capitalisation rules also permit a foreign bank branch – that is, a permanent establishment in Australia of a foreign bank – to be part of a head company for thin capitalisation purposes.

In determining the thin capitalisation position of the group, the values to be used for relevant assets, debts etc. are those required under the thin capitalisation rules.

Note that certain thin capitalisation rules regarding the revaluation of assets have been modified by *Taxation Laws Amendment Act (No. 5) 2003*.[2]

Classification

For the purposes of thin capitalisation, a head company can be classified as:

- an outward investing entity that is not an authorised deposit-taking institution (non-ADI) – general or financial
- an inward investing entity (non-ADI) – general or financial
- an outward investing entity (ADI), or
- an inward investing entity (ADI).

[1] For more information about thin capitalisation groups and the 'cut-off day', see the *Guide to thin capitalisation* at **www.ato.gov.au** or refer to sections 820-455 to 820-457 of the ITAA 1997.

[2] Subsection 820-680(2), section 820-985, ITAA 1997; subsection 262A(3), ITAA 1936.

The classification of the head company of the group is determined for thin capitalisation purposes by the nature of the members of the group. This in turn determines which thin capitalisation rules apply to the head company in a period within the head company's income year. For instance, if there has been a change in the head company's classification during its income year, the thin capitalisation rules that apply in the period before the change are different to those that apply in the period after the change. This can result in the head company having to determine the group's thin capitalisation position more than once in its income year.

Outward investing entity (non-ADI)

The head company is classified as an outward investor (general) in a period if, within that period, one or more members of the group:

- is the Australian controller of an Australian controlled foreign entity, and/or
- carries on business at or through an overseas permanent establishment, or
- is the associate entity (by definition) of an outward investing entity (non-ADI).

→ subsection 820-85, ITAA 1997

For example, the head company is classified as an outward investor (general) if one or more members of the group holds an interest in a controlled foreign company.

In addition, there must not be a member of the group that is a financial entity or an ADI by definition.

If at least one member of the group is a financial entity and no member is an ADI the head company is classified as outward investor (financial). In accordance with the single entity principle, the special thin capitalisation rules that apply to on-lent amounts and zero-capital amounts will therefore apply to all such assets in the group.

In these cases Subdivision 820-B of the thin capitalisation provisions applies to the head company. → subsections 820-583(1) to (3), ITAA 1997

Inward investing entity (non-ADI)

The head company is classified as an inward investment vehicle (general) if it is a foreign controlled Australian company by definition → section 820-785, ITAA 1997. This essentially means the head company must either be actually or effectively controlled by five or fewer foreign entities or be controlled by a single foreign entity that holds a thin capitalisation control interest of at least 40%. For example, the head company of a MEC group would automatically be classified as an inward investing entity (unless it could be classified as an outward investing entity) because of the requirements to form a MEC group.

Again, there must not be a member of the group that is a financial entity or an ADI by definition.

If at least one member of the group is a financial entity and no member is an ADI, the head company is classified as an inward investment vehicle (financial). As before, the special thin capitalisation rules for on-lent amounts and zero-capital amounts will apply.

In these cases Subdivision 820-C of the thin capitalisation rules applies to the head company. → subsections 820-583(4) to (6), ITAA 1997

A head company is excluded from this classification in a period if it can be classified as an outward investing entity (non-ADI) in that period.

Outward investing entity (ADI)

The head company is classified as an outward investing entity (ADI) in a period if it is classified as an outward investing entity and at least one member of the group is an ADI. → subsection 820-583(7), ITAA 1997

In addition, under certain conditions the head company of a MEC group that is not classified as an outward investing entity (ADI) – for example, if it is classified as an inward investing entity – will be treated as if it were classified as an outward investing entity (ADI). This occurs if one member of the MEC group is a foreign controlled Australian ADI by definition and at least one eligible tier-1 company is neither an ADI nor the owner of a wholly-owned subsidiary that is an ADI. → section 820-587, ITAA 1997

With one exception, a choice by a head company to treat an Australian permanent establishment of a foreign bank (a 'foreign bank branch') as part of itself for thin capitalisation purposes results in the head company being classified as an outward investing entity (ADI). This rule applies even where a head company that in itself is an ADI was held to be exempt from the thin capitalisation rules (see below), or where a head company of a MEC group was treated as if it were an outward investing entity (ADI) as described above.

The exception is where the head company is classified as an inward investing entity (non-ADI). The inclusion of the foreign bank branch effectively reclassifies the head company as an inward investing entity (ADI).

The new classification resulting from the inclusion of the foreign bank branch takes precedence over any other classification resulting from Division 820.
→ section 820-609, ITAA 1997

Subdivision 820-D of the thin capitalisation rules applies to a head company that is given this classification.

Modification of adjusted average equity capital calculation

Where a head company is classified as an outward investing entity (ADI), the definition of adjusted average equity capital in Subdivision 820-D is modified to account for non-ADI members of the group (if any), that is, members not supervised by the Australian Prudential Regulation Authority (APRA). The modification requires the inclusion of:

- (consolidated) paid-up share capital (other than debt interests)
- capital of other entities (other than debt interests)
- retained earnings

- general reserves
- asset revaluation reserves, and
- interest-free debt of non-ADI group members.

These amounts are then added to the tier-1 capital (net of included debt capital) of members that are ADIs or wholly-owned subsidiaries of ADIs.

The above equity capital is determined net of any amounts attributable to overseas permanent establishments of the group members. Any controlled foreign equity (net of amounts attributable to overseas permanent establishments) of the members of the group must also be excluded.

A further modification is made where the head company chooses to treat a foreign bank branch as part of itself for thin capitalisation purposes. → 'Foreign bank branches and consolidated groups', C6-1-210

Amounts for this calculation are to be worked out as far as practicable from a set of consolidated accounts that have been prepared in accordance with the accounting standards at the measurement time. These consolidated accounts should cover only the members of the group.

These modifications to the definition of adjusted average equity capital only have effect for the period 1 July 2002 to 30 June 2003. The affected section 820-589 has been repealed effective from 1 July 2003 and is replaced by a new section 820-90 because of the amendments to the definition of equity capital that came into effect on that date.

→ 'Consequences of amendments to the definition of equity capital', p. 5

Modified determination of safe harbour capital amount

The modification to the determination of the safe harbour capital amount results in the risk-weighted assets being reduced by the amount on-lent when the following conditions are satisfied:

- a subsidiary member of a consolidated group is both an ADI and a wholly-owned foreign subsidiary of a foreign bank, and
- the subsidiary member has on-lent amounts, raised from the issue of debentures covered by section 128F of the ITAA 1936, to an Australian permanent establishment of the foreign bank, and
- the Australian permanent establishment has not been chosen to be part of the head company for thin capitalisation purposes.

This modification will be available only until the end of the head company's 2006 income year. → section 820-591, ITAA 1997

Inward investing entity (ADI)

A head company is classified as an inward investing entity (ADI) only where it has chosen to include a foreign bank branch as a member of the group for thin capitalisation purposes → 'Foreign bank branches and consolidated groups', C6-1-210. However, a head company will be excluded from this classification in a period if it can be classified as an outward investing entity in that period.

Subdivision 820-E of the thin capitalisation rules applies, subject to certain modifications, to a head company that has been classified as an inward investing entity (ADI) under the above circumstances. It is noted that the definition of average equity capital in Subdivision 820-E is to be changed as a result of the change to the definition of equity capital effective from 1 July 2003). → section 820-615, ITAA 1997

Amendments

Consequences of amendments to the definition of 'equity capital'

The current definition of equity capital has been repealed and replaced by a generic definition that applies to both ADIs and non-ADIs. In addition, a new concept, 'ADI equity capital', has been introduced. Both changes are effective from 1 July 2003. As a consequence, a number of the provisions that modified the definition of adjusted average equity capital and average equity capital for consolidated groups have also been repealed and replaced. The replacement provisions[3] provide the following:

- For the purposes of applying Subdivision 820-D to a head company of a MEC group, the replacement section 820-589 ensures the inclusion of the ADI equity capital (as defined) of eligible tier-1 companies in a MEC group in the calculation of the adjusted average equity capital of the head company of that group. The definition of adjusted average equity capital no longer requires modification in relation to the head company of a consolidated group except in the circumstances below.
- If a foreign bank branch has been treated as part of a head company to which Subdivision 820-D applies, the replacement subsections 820-613(2) and (3) now include the ADI equity capital (as defined) of the foreign bank that is attributable to the foreign bank branch and any interest-free loans provided by the foreign bank to its Australian branch.
- For the purposes of applying Subdivision 820-E to a head company, the definition of average equity capital as amended by the replacement subsection 820-615(2) includes the ADI equity capital (as defined) of the head company for the test period plus the ADI equity capital of the foreign bank that is attributable to the foreign bank branch and any interest-free loans provided by the foreign bank to its Australian branch.

[3] *Taxation Laws Amendment Act (No. 5) 2003*, Schedule 3 Part 1.

Choice by a financial entity to be treated as an ADI

Rules have been introduced to enable a financial entity to choose to be treated as an ADI where it satisfies conditions referred to as the '80% rule'. This choice can be made only once. → sections 820-430 and 820-435, ITAA 1997

If a head company of a consolidated group has at least one member that is a financial entity and the group satisfies the 80% rule, the head company can choose to be treated as an ADI instead of a financial entity for thin capitalisation purposes → subsections 820-435(2) and (3). Making this choice results in the head company being classified as an outward investing entity (ADI) → subsection 820-430 (1), ITAA 1997.

However, the fact that a member of the group that is a financial entity has itself made a choice to be treated as an ADI will not result in the head company of the group being classified as an ADI. Only a choice by the head company when the above conditions are satisfied can do this.

Example

A financial entity that was a subsidiary member of a consolidatable group (that was not a thin capitalisation group) satisfies the 80% rule. It therefore chooses to be treated as an ADI for thin capitalisation purposes.

Upon consolidation, the head company is prohibited from making the choice to be treated as an ADI because the group does not satisfy the 80% rule. The choice by the subsidiary member of the group therefore ceases to have effect.

This would be the case even if the head company had been able to make the choice but had not done so.

In addition, the choice by a head company to treat a foreign bank branch as part of itself in a period, thereby resulting in the head company being classified as an inward or outward investing entity (ADI), takes precedence over any choice by the head company to be treated as an ADI instead of a financial entity for classification purposes. → former section 820-445, ITAA 1997

The choice by a head company to be treated as an ADI ceases to have effect if it fails to meet the requirements of the 80% rule (the test time being at the end of every third income year) or if the Commissioner provides written approval of a revocation of the choice (which is effective from the date written approval is given or the date revocation is requested if earlier). Once the choice ceases to have effect it cannot be made again. → subsections 820-430(6) and (7) and section 820-440, ITAA 1997

Example

The head company of a consolidated group was classified as an inward investment vehicle (financial) to which Subdivision 820-C applied. The group satisfied the 80% rule so the head company chose to be treated as an ADI. It had not made this choice before. Consequently, the head company was classified as an outward investing entity (ADI) to which Subdivision 820-D applied.

At the beginning of the following income year it chose to treat the foreign bank branch of its parent (a foreign bank) as part of itself. This resulted in the head company being classified as an inward investing entity (ADI) to which Subdivision 820-E applied.

At the beginning of its third income year it did not choose to treat the foreign bank branch as part of itself and so reverted to the classification of outward investing entity (ADI).

If the head company had not satisfied the 80% rule at the end of its third income year, the choice to be treated as an ADI would have ceased to have effect and it would have reverted to the classification of inward investment vehicle (financial) for that income year.

However, choosing to be treated as an ADI does not affect the calculation of an associate entity's associate entity debt, and, subject to certain limitations, the calculation of an associate entity's associate entity capital. → subsection 820-430(4); and Explanatory Memorandum to Taxation Laws Amendment Bill (No. 5) 2003, paragraph 1.30

Exclusion of insolvency remote special purpose entities

For income years beginning on or after 1 July 2001, certain special purpose entities are excluded from the thin capitalisation rules during periods that they meet certain conditions. Such an entity is excluded from the rules in all or part of an income year that it satisfies the following conditions:

- the entity is established for the purposes of managing some or all of the economic risk associated with assets, liabilities or investments (whether the entity assumes the risk from another entity or creates the risk itself), and
- at least 50% of the entity's assets are funded by debt interests, and
- the entity is an insolvency remote special purpose entity according to the criteria of an internationally recognised rating agency applicable to the entity's circumstances.

Where a special purpose entity that satisfies these conditions is a member of a consolidated group or MEC group, that entity will be disregarded for the purposes of determining the group's thin capitalisation position in the income year (or part of the income year) in which the conditions are satisfied. Further, if two or more members of the group together satisfy the requisite conditions and, had they been notionally taken to be divisions of a notional entity, that notional entity would be considered to have satisfied the requisite conditions of the 80% rule, each of those members is disregarded for the purposes of determining the group's thin capitalisation position.

→ sections 820-39 and 820-584, ITAA 1997

Exclusion of head company from thin capitalisation rules

Debt deductions of the head company of a consolidated group will not be disallowed under the thin capitalisation rules where it meets the requirements of either the $250,000 threshold test or the Australian assets threshold test (the de minimis tests). → sections 820-35 and 820-37, ITAA 1997

In addition, debt deductions of the head company of a consolidated group will not be disallowed under the thin capitalisation rules where it cannot be classified as an outward investing entity, and is either:

- a foreign controlled Australian entity and an ADI in its own right, e.g. a foreign controlled bank, or
- a holding company with no debt capital whose only asset is all the membership interests in a foreign controlled Australian entity that is an ADI, e.g. a 'pure' bank holding company. → section 820-585, ITAA 1997

Note

Recent changes to consolidation rules

Recent changes to the *Financial Corporations (Transfer of Assets and Liabilities) Act 1993* ensure that the income tax relief provided by that Act applies appropriately to financial corporations that are members of consolidated groups – see *Taxation Laws Amendment (2004 Measures No. 2) Act 2004* (83 of 2004), Schedule 2, Part 12, 'Financial corporations (Transfer of Assets and Liabilities) Act 1993'.

References

Income Tax Assessment Act 1997, Subdivisions 820-A to E, FA and FB of Division 820

Income Tax Assessment Act 1997; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedules 1 to 3:

- sections 820-39, 820-430, 820-435, 820-440
- former section 820-445
- sections 820-584, 820-589
- subsections 820-613(2) and (3)
- section 820-615
- subsection 820-680(2)

Income Tax Assessment Act 1936; as amended by *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003), Schedule 1: subsection 262A

Explanatory Memorandum to the New Business Tax System (Consolidation and Other Measures) Bill (No. 1) 2002, Chapter 6

Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 2003, Chapter 1

Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 (No. 101 of 2006), which repealed section 820-445 of the *Income Tax Assessment Act 1997*

Revision history

Section C6-1-110 first published 28 May 2003.

Further revisions are described below.

Date	Amendment	Reason
12.5.04	Confirm that information previously based on proposed law accurately reflects the law as enacted – in particular, amendments to the definition of equity capital to cover both ADIs and non-ADIs.	Enactment of *Taxation Laws Amendment Act (No. 5) 2003* (No. 142 of 2003)
14.7.04	Note on recent changes to consolidation rules, p. 8.	Legislative amendments.
15.11.06	Updated references to inoperative provisions.	Legislative amendment.
26.6.07	Change to reference.	To correct error.

Proposed changes to consolidation

Proposed changes to consolidation announced by the Government are not incorporated into the *Consolidation reference manual* until they become law. In the interim, information about such changes can be viewed at:

- **http://assistant.treasurer.gov.au** (Assistant Treasurer's press releases)
- **www.treasury.gov.au** (Treasury papers on refinements to the consolidation regime).