

Foreign bank branches and consolidated groups

Note

MEC groups and foreign bank branches

The rules for foreign bank branches and consolidated groups also apply to multiple entry consolidated (MEC) groups. For the purposes of this section, 'consolidated groups' includes MEC groups.

Grouping of foreign bank branches

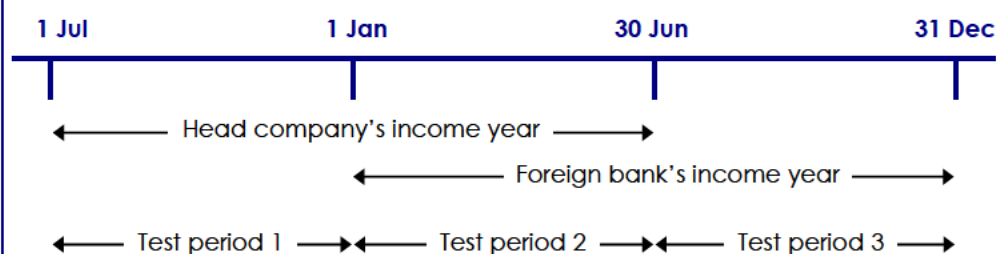
From 1 July 2002, a head company of a consolidated group can make a choice each income year to have the Australian permanent establishment of a foreign bank (a 'foreign bank branch') treated as part of the head company for the purposes of applying the thin capitalisation provisions in that income year. This can occur when a head company of a consolidated group and a foreign bank are members of the same wholly-owned group and the foreign bank carries on its business through a foreign bank branch. The period in the head company's income year in which the above conditions are met is the 'grouping period'. The period for which the choice is made cannot be shorter than the grouping period within an income year. → section 820-597, ITAA 1997

Subdivision 820-FB applies to the head company where this choice is made.

Where the head company's income year differs from that of the foreign bank, and hence the foreign bank branch, separate thin capitalisation calculations must be made for each period that relates to different income years for the respective taxpayers – that is, there may be more than one test period within a grouping period.

Example

The head company of a consolidated group and a foreign bank are members of the same wholly-owned group. The head company and the foreign bank have income years ending 30 June and 31 December respectively. The head company chooses to treat the foreign bank's Australian branch as part of itself for thin capitalisation purposes. The test periods for which thin capitalisation calculations must be made are shown in the figure below.



The combined calculations for test periods 1 and 2 determine any disallowed deductions for the head company and the combined calculations for test periods 2 and 3 determine any disallowed deductions for the foreign bank.

Where the head company makes the choice for a grouping period for an income year, it is binding on both the head company and the foreign bank and cannot be revoked. Once the choice is made the foreign bank branch is treated as a subsidiary of the consolidated group, for thin capitalisation purposes, rather than a part of the foreign bank. As such, any assets, liabilities and incurred debt deductions attributable to the foreign bank branch are treated as separate to those of the foreign bank. The foreign bank, however, is still required to keep records in relation to the foreign bank branch in accordance with Subdivision 820-L. → section 820-603, ITAA 1997

Subdivision 820-L has been amended¹ to allow inward investors carrying on business in Australia at or through a permanent establishment to satisfy the record keeping requirements where financial statements have been prepared using certain international accounting standards.

Foreign bank branches can also group with a single resident company that is not a member of a consolidated group².

Modifications to Subdivision 820-D

Where a head company that has chosen to treat a foreign bank branch as part of itself for thin capitalisation purposes is classified as an outward investing entity (ADI), the following additional modifications to the rules in Subdivision 820-D, as they apply to a head company, are required:

- the definition of adjusted average equity capital is further modified to include certain equity capital of the foreign bank branch and any interest-free loans made by the foreign bank to the branch, and
- the risk-weighted assets of the head company will also include certain risk-weighted assets of the foreign bank attributable to the foreign bank branch (excluding those allocated to offshore banking activities).

Note

Definition of 'equity capital'

Because of the change to the definition of 'equity capital' (effective from 1 July 2003), the modification to the adjusted average equity capital definition only has effect for the period 1 July 2002 to 30 June 2003. As a consequence subsections 820-613(2) and (3) have been repealed and replaced.

→ 'Thin capitalisation and consolidated groups', C6-1-110

¹ *Taxation Laws Amendment Act No. 5 2003* (No. 142 of 2003), Schedule 2 Part 2.

² For more information see the *Guide to thin capitalisation for ADIs (E)* at www.ato.gov.au

Modifications to Subdivision 820-E

Where a head company has chosen to treat a foreign bank branch as part of itself for thin capitalisation purposes – resulting in the head company being classified as an inward investing entity (ADI) – the following additional modifications to the rules in Subdivision 820-E, as they apply to a head company, are required:

- The definition of average equity capital in Subdivision 820-E is modified to include:
 - (consolidated) paid-up share capital (less debt interest amounts)
 - capital of other entities (other than debt interests)
 - retained earnings
 - general reserves
 - asset revaluation reserves
 - interest-free debt of group members
 - equity capital of the foreign bank attributable to the foreign bank branch (excluding amounts allocated to offshore banking activities), and
 - interest-free debt of the foreign bank branch in relation to loans from the foreign bank.
- For the purpose of determining the safe harbour capital amount of the head company, the risk-weighted assets include certain risk-weighted assets of the foreign bank attributable to the foreign bank branch (excluding those allocated to offshore banking activities). The total risk-weighted assets is then multiplied by 4% to give the safe harbour capital amount.

Note

Definition of 'equity capital'

Because of the change to the definition of 'equity capital' (effective from 1 July 2003), the definition of average equity capital is also changed. This is discussed in the section above on consequences of the change to the definition of equity capital.

→ 'Thin capitalisation and consolidated groups', C6-1-110

→ section 820-615, ITAA 1997

Determining thin capitalisation values and amounts

Values and amounts used for thin capitalisation purposes are determined in accordance with the single entity principle, that is, intragroup transactions are ignored. These values and amounts 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. → section 820-611, ITAA 1997

Effect on foreign bank if certain debt deductions disallowed

A foreign bank may incur a debt deduction that is attributable to a foreign bank branch that has been treated as part of a head company under Subdivision 820-FB. Because the foreign bank branch is treated as part of the head company for thin capitalisation purposes, the debt deduction is also treated as a deduction of the head company for those purposes. Where all or part of the relevant debt deduction has been disallowed due to the operation of the thin capitalisation provisions to the head company, the whole or part of the deduction is disallowed to the foreign bank.

Example

The head company of a consolidated group and a foreign bank are both members of the same wholly-owned group. The foreign bank has an Australian permanent establishment (the foreign bank branch).

The head company incurs and is treated as having incurred \$500,000 of debt deductions, of which \$100,000 relates to the foreign bank branch that the head company has chosen to treat as a part of itself. Neither debt deduction arises because of a debt arrangement between the head company and the foreign bank via its branch, i.e. it all relates to external debt.

The head company fails the thin capitalisation test and \$200,000 of the total debt deduction is disallowed. As a result, the head company is disallowed a deduction to the extent of \$160,000 against the assessable income of the consolidated group and the foreign bank is disallowed a deduction to the extent of \$40,000 against the assessable income of the foreign bank branch.

There is an exception to this provision where the cost of the debt deduction attributable to the foreign bank branch, and incurred during the grouping period, gives rise to an amount paid or owed to the head company as representative of the consolidated group. This type of effective intragroup debt deduction is disregarded for thin capitalisation purposes. The same result arises where a head company incurs a debt deduction the cost of which is paid or owed to the foreign bank branch that is being treated as part of the head company under Subdivision 820-FB.

Example

The head company of a consolidated group and a foreign bank are both members of the same wholly-owned group. The foreign bank has an Australian permanent establishment (the foreign bank branch).

The head company borrows funds from the foreign bank via its foreign bank branch, upon which it incurs a \$2,000,000 debt deduction. The head company also borrows funds from a third party, upon which it incurs a \$3,000,000 debt deduction. The head company treats the foreign bank branch as a part of itself for thin capitalisation purposes. The \$2,000,000 debt deduction is treated as if it arose from an intragroup loan arrangement and is therefore disregarded for the purposes of thin capitalisation. Consequently, the full \$2,000,000 is available to the head company as an allowable deduction against the consolidated group's assessable income. → section 820-605, ITAA 1997

References

Income Tax Assessment Act 1997, Subdivisions 820-D, E 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 2 and 3:

- sections 820-613, 820-615, 820-960

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

Revision history

Section C6-1-210 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 and treatment of inward investors. | Enactment of <i>Taxation Laws Amendment Act (No. 5) 2003</i> (No. 142 of 2003) |

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).