# Public advice and guidance compendium – TD 2020/2

**Relying on this Compendium**

This Compendium of comments provides responses to comments received on draft Taxation Determination TD 2018/D4 *Income tax: thin capitalisation - valuation of debt capital for the purposes of Division 820*. It is not a publication that has been approved to allow you to rely on it for any purpose and is not intended to provide you with advice or guidance, nor does it set out the ATO's general administrative practice. Therefore, this Compendium does not provide protection from primary tax, penalties or interest for any taxpayer that purports to rely on any views expressed in it.

## Summary of issues raised and responses

| Issue number | Issue raised | ATO response |
|---|---|---|
| 1 | Debt capital is a subset of liabilities, therefore the value of a compound financial instrument that is debt capital is limited to the value of the liability component.<br>Calculation of debt capital must follow the accounting standards and the value should not incorporate the equity component recognised for accounting purposes. | As per the ATO's view, limiting the value of debt capital to the part that is classified as financial liability under the accounting standards is inconsistent with section 820–680 of the *Income Tax Assessment Act 1997*[1], the context in which the provision operates, and the object of Division 820 as a whole.<br>Also refer to Appendix 2 - Alternative view of the Determination, which explains why this alternative view is not supported by the ATO. Accordingly, we disagree with the views submitted. |
| 2 | If mandatorily redeemable preference shares (MRPS) are debt capital giving rise to debt deduction, subsection 820-680(1)(b) requires that the value of the MRPS included in the Step 1 calculation is the accounting liability. | Refer to Appendix 2 - Alternative view of the final Determination which explains why the alternative view is not supported by the ATO. Accordingly, we disagree with the views submitted.<br>Also, under Division 820, an entity while working out its adjusted average debt must, among other things, include all of its debt capital that gives rise to debt deductions. Refer to TD 2019/12 *Income tax: what type of costs are debt deductions within scope of subparagraph 820-40(1)(a)(iii) of the Income Tax Assessment Act 1997?* for the ATO's view on what type of costs are debt deductions within scope of subparagraph 820–40(1)(a)(iii). |
| 3 | The ATO's position is that the value of debt capital is the sum of the liability and the equity components of the compound | The ATO is of the view that an entity's debt capital must be valued in its entirety in the manner required by the accounting standards |

[1] All legislative references in this Determination are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

| | | |
|---|---|---|
| | financial instrument. Therefore, the value of debt capital will accrete in future years above the value of the funds received from the compound financial instrument. The value of debt capital should not exceed the face value of the instrument.<br>An interpretation of section 820–680 that would result in recognising an amount of debt capital that is in excess of the face value of the instrument would appear inconsistent with the scheme and the purpose of the thin capitalisation regime. If this is the intended outcome, it should be made explicit, including by expanding Example 3 to include a worked example covering both the year of issue of the instrument and subsequent years.<br>If the Commissioner considers that the value of debt capital in accordance with the accounting standards is the sum of the liability component and the equity component, the value of debt capital should be capped at the instrument face value to avoid nonsensical outcomes. | regardless of whether it comprises debt interests that are classified as financial liabilities, equity instruments or compound financial instruments under the accounting standards.<br>Example 3 has been expanded in the final Determination to illustrate the ATO's approach to determining the value of debt capital, for thin capitalisation purposes, as at the issue date of the MRPS. The purpose of this example (and the Determination more broadly) is to state the ATO's view that the provisions do not operate to confine the value of debt capital strictly to that classified as a financial liability under the accounting standards. We consider that Example 3 included in the final Determination is sufficient in dealing with the issue. |
| 4 | TD 2018/D4 may have broader consequences that need to be explored. For example, impact on financial instruments that include a derivative element, interest-free loans and other values that are required to be calculated in accordance with accounting standards (for example, non–debt liabilities, excluded equity interests, associated entity equity, associated entity debt, cost free debt, etcetera) | The ATO notes the views expressed in the submissions. In the ATO's view no changes were required to the draft Determination for the matter. |
| 5 | It is not clearly explained how section 820–690 and Subdivision 815–B are relevant to the Determination. The assertion regarding use of powers under section 820–690 is not supported and does not address alternative arguments. | Refer to paragraphs 6 and 7 of the final Determination for the ATO's view on section 820–690 and Subdivision 815–B. Where an entity has limited the value of debt capital to the accounting liability component, the Commissioner considers that it has undervalued its liabilities (including debt capital) as only a component of the debt capital is subject to valuation. Therefore, in our view, section 820-690 is enlivened. Section 820–690 gives the Commissioner power to substitute the value of liabilities (including debt capital) to an appropriate value having regard to the accounting standards and Subdivision 820-G. In this case, we believe that that the exclusion of the accounting liability component has the effect of undermining the intent and operation of Division 974, as well as the intent of the thin capitalisation provisions in Division 820. Accordingly, we believe that |

| | | |
|---|---|---|
| | | section 820–690 is relevant to the Determination.<br>Also refer to TD 2019/10 *Income tax: can the debt and equity rules in Division 974 of the Income Tax Assessment Act 1997 limit the operation of the transfer pricing rules in Subdivision 815-B of the Income Tax Assessment Act 1997?* for the ATO's view that debt and equity rules in Division 974 do not limit the operation of the transfer pricing rules in Subdivision 815–B. Accordingly, we believe that Subdivision 815–B is relevant to the Determination. |
| 6 | Example 3 does not explain how the new ATO approach is in accordance with the accounting standards as required by sections 820–680 and 820–690. The alternative approach outlined in Appendix 2 – Alternative view of the draft Determination results in the outcome of the accounting standards using a present value calculation. | Example 3 has been expanded in the final Determination to show valuation of the MRPS as consisting of a liability and an equity component.<br>Refer to Appendix 2 – Alternative view of the Determination which explains why the alternative view is not supported by the ATO. We disagree with the views submitted. |
| 7 | Accounting by investor and issuer of zero coupon bonds was provided in the submission. It was suggested that a worked example of a zero coupon bond should be included in the Determination. | The Determination deals with valuation of debt capital for the purposes of Division 820. We consider that the guidance on zero coupon bonds is outside the scope of the Determination as the Determination does not deal with issues unrelated to application of Division 820 such as the taxation of financial arrangement provisions. |
| 8 | The view in the Determination deviates from the ATO's position in TR 2002/20 *Income tax: Thin Capitalisation - Definition of assets and liabilities for the purposes of Division 820*, which states at paragraphs 6 and 31 that the value of assets and liabilities (including that of the debt capital) must comply with accounting standards. | Refer to paragraph 3 of the final Determination which states that subsection 820–680(1)(b) requires an entity to comply with the accounting standards in calculating the value of its liabilities (including its debt capital). |
| 9 | It is recommended that the Determination should have a prospective date of effect.<br>It was also suggested that ATO views should grandfather existing arrangements and the ATO views should apply to the arrangements that are entered into on or after the date of issue of final Determination. | The ATO considers that the Determination should apply both before and after its date of issue.<br>The ATO has previously expressed its concerns in respect of valuation of debt capital treated wholly or partly as equity for accounting purposes in Taxpayer Alert TA 2016/9 *Thin capitalisation - Incorrect calculation of the value of 'debt capital' treated wholly or partly as equity for accounting purposes*, which issued on 10 August 2016. TA 2016/9 stated that the ATO will take the approach of valuing the debt capital in the same manner as that contained in this Determination. |

| | | |
|---|---|---|
| 10 | A taxpayer's thin capitalisation position must preserve the balance between assets, liabilities and equity. The accounting equation that a firm's assets equal sum of its liabilities its equity could be thrown out of balance where debt capital is a subset of liabilities. | In the ATO's view, application of the Determination does not lead to an entity being unable to preserve balance between assets, liabilities and equity. |