

TD 2018/D4 - Income tax: thin capitalisation - valuation of debt capital for the purposes of Division 820

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This document has been finalised by TD 2020/2.

⚠ There is a Compendium for this document: **TD 2020/2EC** .



Draft Taxation Determination

Income tax: thin capitalisation – valuation of debt capital for the purposes of Division 820

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What this draft Ruling is about

1. This draft Determination sets out how an entity must value its 'debt capital' for the purposes of Division 820 of the *Income Tax Assessment Act 1997*.¹
2. The concept of 'debt capital' is used, among other things, to work out a non-ADI entity's² 'adjusted average debt' for the purposes of the thin capitalisation rules in sections 820-85 and 820-185.

Ruling

3. Paragraph 820-680(1)(b) requires an entity to comply with the accounting standards in calculating 'the value of its liabilities (including its *debt capital)'.
*debt capital
4. The 'debt capital' of an entity at a particular time is defined in section 995-1 to mean any debt interests issued by the entity that are still on issue at that time. A 'debt interest' in an entity has the meaning given in Subdivision 974-B.
5. The language of paragraph 820-680(1)(b) makes it clear that an entity's debt capital, as defined in section 995-1, is a category of liabilities for the purposes of Division 820. This means 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 draft Determination are to the *Income Tax Assessment Act 1997* unless otherwise stated.

² ADI' stands for 'authorised deposit-taking institution' and is defined in section 995-1 to mean a body corporate that is an ADI for the purposes of the *Banking Act 1959*.

6. This is so whether the entity's debt capital comprises debt interests that are classified as financial liabilities, equity instruments or compound financial instruments under the accounting standards. The treatment of an entity's debt capital as a class of liabilities for the purposes of Division 820 is not altered by the accounting standards.

7. Pursuant to section 820-690, if the Commissioner considers that an entity has undervalued its liabilities (including its debt capital) in relation to a calculation under Division 820, the Commissioner may, having regard to the accounting standards and Subdivision 820-G, substitute a value that the Commissioner considers is appropriate.

8. The transfer pricing rules in Subdivision 815-B may also operate to substitute the arm's length conditions for the actual conditions that operate between an entity and another entity in connection with their commercial or financial relations, including in relation to the entity's debt capital.

Example 1: loan note

9. *ABC Ltd issues a loan note to raise \$50 million. The loan note pays interest at the rate of 3.5%. Based on the terms of the note, it is treated as debt capital for the purposes of Division 820 and classified as a financial liability under the accounting standards.*

10. *ABC Ltd is required to include the value of the loan note in its adjusted average debt for the purposes of Division 820. The loan note must be valued in its entirety in accordance with the requirements contained in the accounting standards.*

11. *ABC Ltd values the loan note at \$50 million less principal repayments made up to the date of valuation. The Commissioner considers that this valuation is appropriate.*

Example 2: perpetual note

12. *EFG Ltd issues a perpetual note to raise \$75 million. The principal amount and any deferred interest are payable in full on liquidation ahead of equity. However, if the principal amount and any deferred interest are not paid within 10 years, the interest rate thereafter increases by a very significant amount. Based on the terms of the note, it is treated as debt capital for the purposes of Division 820, but is classified as an equity instrument under the accounting standards.*

13. *EFG Ltd is required to include the value of the perpetual note in its adjusted average debt for the purposes of Division 820. The perpetual note must be valued in its entirety in accordance with the requirements contained in the accounting standards.*

14. *EFG Ltd values the perpetual note at \$75 million less principal repayments made up to the date of valuation. The Commissioner considers that this valuation is appropriate.*

Example 3: mandatorily redeemable preference shares

15. XYZ Ltd issues 30,000 mandatorily redeemable preference shares (MRPS) at \$1,000 each to raise \$30 million. The MRPS carry a cumulative dividend of 3.5% per annum and must be redeemed by XYZ within nine years of issue. The payment of dividends is at the discretion of XYZ and any accumulated dividends that remain unpaid at redemption are not added to the redemption amount. Based on the terms of the MRPS, the MRPS are treated as debt capital for the purposes of Division 820, but are classified as compound financial instruments under the accounting standards.

16. XYZ Ltd is required to include the value of the MRPS in its adjusted average debt for the purposes of Division 820. The MRPS must be valued in their entirety in accordance with the requirements contained in the accounting standards.

17. XYZ Ltd values the MRPS at \$30 million less capital repayments made up to the date of valuation. The Commissioner considers that this valuation is appropriate.

Date of effect

18. When the final Determination is issued, it is proposed to apply both before and after its date of issue.

19. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation

1 August 2018

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

20. The object of Division 820, as set out in section 820-30, is to ensure that certain entities do not reduce their tax liabilities by using excessive amounts of debt capital to finance their Australian operations. For non-ADI entities, this object is achieved by the thin capitalisation rules in sections 820-85 and 820-185. These rules, which apply depending on whether an entity is an outward investing entity (non-ADI) or an inward investing entity (non-ADI), operate to disallow all or a part of each debt deduction of an entity for an income year if the entity’s adjusted average debt exceeds its maximum allowable debt.

21. A non-ADI entity’s adjusted average debt is the result of applying the method statement in subsections 820-85(3) or 820-185(3). The first step in the method statement requires an entity to work out the average value, for the relevant year, of ‘all the *debt capital of the entity that gives rise to *debt deductions of the entity for that or any other income year.’ For these purposes, the ‘debt capital’ of an entity at a particular time is defined in section 995-1 to mean any debt interests issued by the entity that are still on issue at that time. A ‘debt interest’ in an entity has the meaning given in Subdivision 974-B.

22. For the purposes of Division 820, average values are required to be worked out in accordance with Subdivision 820-G. Subsection 820-680(1), which is part of Subdivision 820-G, provides:

For the purposes of this Division, an entity must comply with the *accounting standards in determining what are its assets and liabilities and in calculating:

- (a) the value of its assets (including revaluing its assets for the purposes of that calculation); and
- (b) the value of its liabilities (including its *debt capital); and
- (c) the value of its *equity capital.

23. The word ‘liabilities’ in paragraph 820-680(1)(b) is a reference to an entity’s liabilities, including its ‘debt capital’ and ‘non-debt liabilities’ as defined in section 995-1. The parenthetical statement ‘liabilities (including its *debt capital)’ makes it clear that, for the purposes of Division 820, an entity’s liabilities include the entirety of its debt capital as defined. This is so whether the entity’s debt capital comprises debt interests that are classified as financial liabilities, equity instruments or compound financial instruments under the accounting standards. The treatment of debt capital as a class of liabilities for the purposes of Division 820 is not altered by the accounting standards.

24. It follows that an entity’s debt capital is a category of liabilities for the purposes of Division 820 and must be valued in its entirety in the manner required by the accounting standards. That is, an entity is required to comply with the accounting standards in calculating the value of all of its debt capital as defined, notwithstanding that it may comprise debt interests that are classified wholly or partly as equity, rather than as financial liabilities, under the accounting standards.

Appendix 2 – Alternative views

❶ *This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.*

25. There is an opposing argument that the value of an entity's debt capital, calculated in compliance with the accounting standards, is limited to the value of that part of the debt capital that is classified as a financial liability for accounting purposes. On this view, the parenthetical statement in paragraph 820-680(1)(b) indicates that only the accounting liability value of debt capital is relevant for the purposes of Division 820. A consequence of this view is that an entity's debt capital has no value for the purposes of Division 820 to the extent that it comprises debt interests that are classified wholly or partly as equity, rather than as financial liabilities, under the accounting standards.

26. The Commissioner disagrees with this view. The Commissioner considers that it is wholly inconsistent with the language of section 820-680, the context in which that provision operates, and the object of Division 820 as a whole. The concept of 'debt capital' is central to determining an entity's adjusted average debt for the purposes of Division 820. The statutory task under subsections 820-85(3) and 820-185(3) is to calculate the average value of all the debt capital of an entity, as defined, that gives rise to debt deductions. Paragraph 820-680(1)(b) as properly construed requires an entity to comply with the accounting standards in performing this statutory task. The accounting classification of an entity's debt capital is not relevant (because it is already treated as a category of liabilities). The provisions do not operate to confine the calculation of value to that part of the debt capital that is classified as a financial liability under the accounting standards.

Appendix 3 – Your comments

27. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

28. A compendium of comments is prepared for the consideration of the relevant Public Advice and Guidance Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments, and
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **31 August 2018**

Contact officer details have been removed following publication of the final determination.

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Legislative references:

- ITAA 1997
- ITAA 1997 820-680(1)(b)
- ITAA 1997 995-1
- ITAA 1997 SubDiv 815-B

- ITAA 1997 Div 820
 - ITAA 1997 SubDiv 820-G
 - ITAA 1997 820-85
 - ITAA 1997 820-85(3)
 - ITAA 1997 820-185
 - ITAA 1997 820-185(3)
 - ITAA 1997 820-690
 - ITAA 1997 SubDiv 974-B
 - Banking Act 1959
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ATO references

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