



TD 2018/D5 - 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 ?

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This document has been finalised by TD 2019/12.

 There is a Compendium for this document: **TD 2019/12EC** .



Draft Taxation Determination

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*?

❶ This publication provides you with the following level of protection:

This publication is a draft for public comment. It represents the Commissioner's preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. Under Division 820¹, as it applies to non-ADI² entities, an entity must work out its adjusted average debt. In calculating its adjusted average debt, the non-ADI entity must, among other things, include all of its debt capital³ that gives rise to debt deductions.⁴
2. One category of debt deductions, under subparagraph 820-40(1)(a)(iii), is 'any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under the scheme giving rise to the debt interest'.
3. The following (without limitation) are examples of costs within the scope of subparagraph 820-40(1)(a)(iii):
 - (a) tax advisory costs incurred in relation to the debt capital, which relate to activities including, but not limited to, agreement drafting and valuation of the debt capital
 - (b) establishment fees
 - (c) fees for restructuring a transaction

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*.

³ 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.

⁴ The meaning and scope of 'debt deduction' are also relevant to ADI entities for Division 820 purposes.

- (d) stamp duties
- (e) regulatory filing fees (for example Australian Securities and Investments Commission lodgement fees)
- (f) legal costs of preparing documentation associated with the debt capital, and
- (g) costs to maintain the right to draw down funds.

4. The Commissioner considers all deductible costs of raising finance through debt capital, incurred directly in relation to the debt capital⁵, and all deductible costs directly incurred in maintaining the financial benefit received in association with the debt capital⁶, to be debt deductions within scope of subparagraph 820-40(1)(a)(iii). The use of the words ‘...obtaining or maintaining the financial benefits received, or to be received’ in subparagraph 820-40(1)(a)(iii) indicates the costs can either be incurred prior to the establishment of the debt capital or after the establishment of the debt capital, as long as the costs relate to obtaining or maintaining the financial benefits received or to be received by the entity, in relation to the debt capital.

5. If a non-ADI entity’s debt capital gives rise to debt deductions in an income year, then the entity shall include the average value, for that year, of the debt capital, in its adjusted average debt, in accordance with the method statements for calculating adjusted average debt.⁷

Example: tax advisory costs incurred by issuer of mandatorily redeemable preference shares

6. *Aus Co, a non-ADI entity, engages external advisors for tax, legal and other advice before finalising its issue of mandatorily redeemable preference shares (MRPS) to related Foreign Co to raise financing for its Australian operations. Aus Co requests advice on the following matters:*

- *the design of the MRPS (including the tax consequences of its implementation) and the drafting of the MRPS agreement (including the terms and conditions), and*
- *determining a benchmark rate of return and the arm’s length price for the MRPS.*

7. *Aus Co incurs a liability to pay the external advisors during and at the end of the engagement. Therefore, Aus Co has incurred debt deductions directly related to the MRPS and is required to include the value of the MRPS in its adjusted average debt calculation for the purposes of Division 820.*

⁵ See paragraph 1.59 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (EM).

⁶ See paragraph 1.60 of the EM.

⁷ See for example, subsections 820-85(3) and 820-185(3).

Date of effect

8. When the final Determination is issued, it is proposed to apply both before and after its date of issue. 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 Taxation1 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.*

Relevance of debt deductions for thin capitalisation rules in Division 820

9. The objective of the thin capitalisation provisions in Division 820 is to ensure a multinational entity does not allocate an excessive amount of debt to its Australian operations.⁸

10. Under the thin capitalisation provisions, for non-ADI entities, all or part of each debt deduction (broadly, interest and other costs of borrowing) of the entity for an income year is disallowed when the entity’s adjusted debt average exceeds its maximum allowable debt.

11. Adjusted average debt is worked out by the method statement in subsection 820-85(3) for entities that are outward investing entities (non-ADI), and by the method statement in subsection 820-185(3) for entities that are inward investing entities (non-ADI) and are not also outward investing entities (non-ADI).

12. Step 1 of the method statement at subsection 820-85(3) and subsection 820-185(3) relevantly states:

Work out the average value, for that year (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.

13. ‘Debt capital’ is defined under section 995-1:

‘**debt capital**’, of an entity and at a particular time, means any *debt interests issued by the entity that are still *on issue at that time.

14. ‘Debt deduction’ is defined broadly under subsection 820-40(1):

820-40(1)

Debt deduction, of an entity and for an income year, is a cost incurred by the entity in relation to a *debt interest issued by the entity, to the extent to which:

- (a) the cost is:
 - (i) interest, an amount in the nature of interest, or any other amount that is calculated by reference to the time value of money; or
 - (ii) the difference between the *financial benefits received, or to be received, by the entity under the *scheme giving rise to the debt interest and the financial benefits provided, or to be provided, under that scheme; or
 - (iii) any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under the scheme giving rise to the debt interest; or
 - (iv) any other expense incurred by the entity that is specified in the regulations made for the purposes of this subparagraph; and⁹

⁸ Paragraph 1.2 of the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002.

⁹ To date, there are no regulations for the purposes of subparagraph 820-40(1)(a)(iv).

- (b) the entity can, apart from this Division, deduct the cost from its assessable income for that year.’

15. Subsection 820-40(2) lists a number of types of expenditure that are within paragraph 820-40(1)(a). Subsection 820-40(3) identifies several types of excluded expenditure.

The meaning of ‘directly incurred’ in subparagraph 820-40(1)(a)(iii)

16. Paragraphs 1.59 and 1.60 of the Explanatory Memorandum to the Bill introducing the thin capitalisation rules¹⁰ (the EM) provides further information on what is meant by ‘costs directly incurred in obtaining or maintaining that benefit...’ and cites specific examples of debt deductions relating to subparagraph 820-40(1)(a)(iii).

1.59 An entity can incur costs directly in connection with debt capital other than interest or other amounts that compensate the provider of debt finance for the time the acquirer of the finance has the use of the funds. **For example, there are costs of raising debt finance, such as establishment fees, fees for restructuring a transaction, stamp duty and legal costs of preparing documentation. These sorts of costs are costs of receiving the funds** [emphasis added].

1.60 Once the funds have been raised, there may be other costs that the entity has to pay the finance provider that are directly incurred in maintaining the financial benefit received, for example, costs that are to maintain the right to draw down funds. To the extent that these costs can be deducted by the entity they are debt deductions.

17. Subsection 820-40(1) formerly contained paragraph (c)¹¹, which served to exclude the undeducted component of pre-July 2001 borrowing expenses being claimed under section 25-25¹² from the scope of ‘debt deduction’.¹³ Paragraph 820-40(1)(c) became inoperative and was repealed once section 25-25 borrowing expenses relating to debt interests issued before the enactment of Division 820 had been fully deducted.¹⁴ Its repeal does not affect the conclusion that borrowing expenses are within the meaning of ‘debt deduction’.

18. The character of costs that are borrowing expenses is unchanged even if an entity does not claim a deduction for such costs under section 25-25, or a deduction was claimed for such costs under another provision. Such costs will still be considered a debt deduction within scope of subparagraph 820-40(1)(a)(iii). This view is consistent with paragraph 820-40(1)(b), which requires that debt deductions be costs that can be deducted in that year, apart from the operation of Division 820. That is, the actual act of the entity claiming (or not claiming) a deduction on the borrowing expenses is not relevant to its inclusion as a debt deduction for the purposes of Division 820.

19. Section 25-25 borrowing expenses are not costs of the type described in subparagraphs 820-40(1)(a)(i) and (ii). The Commissioner considers that such expenses are included in subparagraph 820-40(1)(a)(iii), as ‘*any amount directly incurred in obtaining or maintaining the financial benefits received, or to be received, by the entity under the scheme giving rise to the debt interest*’.

¹⁰ Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.

¹¹ Paragraph 820-40(1)(c) formerly read: ‘(c) the cost is not incurred before 1 July 2001 if the entity can deduct it under section 25-25 of this Act or former section 67 of the *Income Tax Assessment Act 1936*.’

¹² Or its predecessor, former section 67 of the ATAA 1936.

¹³ See also paragraph 1.63 of the EM.

¹⁴ Repealed in 2006, with effect commencing 1 Jan 2008. See Schedule 3 of the *Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006*.

Appendix 2 – Your comments

20. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

21. 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 1936
- ITAA 1936 former section 67
- ITAA 1997
- ITAA 1997 25-25
- ITAA 1997 Div 20
- ITAA 1997 820-40
- ITAA 1997 820-40(1)
- ITAA 1997 820-40(1)(a)
- ITAA 1997 820-40(1)(a)(i)
- ITAA 1997 820-40(1)(a)(ii)
- ITAA 1997 820-40(1)(a)(iii)
- ITAA 1997 820-40(1)(a)(iv)
- ITAA 1997 820-40(1)(b)

- ITAA 1997 820-40(1)(c)
- ITAA 1997 820-40(2)
- ITAA 1997 820-40(3)
- ITAA 1997 820-85
- ITAA 1997 820-85(3)
- ITAA 1997 820-185
- ITAA 1997 820-185(3)
- ITAA 1997 Div 974
- ITAA 1997 Subdiv 974-B
- ITAA 1997 995-1
- Banking Act 1959
- Tax Laws Amendment (Repeal of Inoperative Provisions) Act 2006 Sch 3

Other references:

- Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001
- Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 2002

ATO references

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