

IT 2479 - Income tax : application of thin capitalisation rules

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INCOME TAX : APPLICATION OF THIN CAPITALISATION RULES

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THIN CAPITALISATION BY
NON-RESIDENTS

DIVISION 16F

PREAMBLE

1. This ruling considers practical aspects of the operation of the thin capitalisation rules in the income tax law.

2. These rules are contained in Division 16F of the Income Tax Assessment Act 1936 and generally apply from 1 July 1987. They replace a condition for approval of investments that was previously imposed under the Government's foreign investment policy. The rules are intended to prevent significant losses of revenue that could otherwise arise where non-resident investors maintain a high level of debt owing to them in comparison with their equity in their Australian income-producing activities.

3. Where a non-resident has a 15 per cent or greater control of an Australian entity or business, statutory ratios limiting the extent to which debt can exceed equity are imposed on "in-house" funds obtained from overseas. Where foreign debt from "in-house" sources exceeds debt/equity ratios of 6 to 1 for financial institutions and 3 to 1 for all other investors deductions for interest payments will be limited to those on debt falling within the relevant ratio.

4. Enquiries have indicated that it would be desirable to explain how some aspects of the legislation will be administered. This ruling covers areas such as the measurement of foreign debt and foreign equity, the determination of what constitutes a resident company group, the operation of the part-year provisions and the Australian-owned non-resident company provisions.

RULING

FOREIGN DEBT

5. Section 159GZF defines "foreign debt" to include only interest-bearing debt owing directly to foreign controllers and their non-resident associates. However, the anti-avoidance provisions in Subdivision B ensure that where, under a scheme, the debt is indirectly owed to foreign controllers or their non-resident associates, the debt will be counted as "foreign debt". "Foreign debt" does not include debt owing to resident associates of foreign controllers, interest-free non-arm's length debt or any arm's-length debt.

Back-to-back loans - section 159GZO

6. Section 159GZO applies to back-to-back loans, i.e., loans made by foreign controllers or their non-resident associates to their Australian investments where funding is channelled through one or more interposed entities. Where a person is interposed between foreign controllers and their Australian investments, any loans made through the intermediary are treated as if they had been made directly from the foreign controllers to the Australian entity. In effect, this provision disregards the apparent arm's-length lending from the intermediary to the Australian entity and instead looks to the foreign controllers or their non-resident associates as the true source of the funds.

7. It has been suggested that section 159GZO could apply to situations where funding by way of interest-bearing debt and equity follow the same path. The basic object of the thin capitalisation rules is to ensure that a balance is maintained between debt funding and equity invested by non-residents in Australian investments. For this reason, the anti-avoidance provisions in section 159GZO do not generally apply in situations where debt funding follows the chain of equity investment. For example, if a foreign controller invested \$1 million in a resident company and also lent the company \$2 million at interest and the company then invested part of the funds as loans to its subsidiary company, section 159GZO would not apply to treat the loans to the subsidiary company as if they had been lent directly by the foreign controller to the subsidiary company (as in diagram 1, Appendix A).

8. A non-resident investor may have an investment in an Australian holding company which in turn has several subsidiaries so that the investor has more than one arm of investment into at least one of the subsidiaries. In these circumstances, section 159GZO will not be applied if the debt funding is channelled through the chain of investment with the greatest amount of foreign equity (as in diagram 2, Appendix A). Where the amounts of foreign equity are equal, (as in diagram 3, Appendix A) debt funds may be introduced through either or both chains of investment.

Foreign debt - "interest is or may become payable" - section 159GZF

9. The thin capitalisation rules measure foreign debt at its highest point for the year to determine whether the appropriate debt/equity ratio has been complied with. Because of this, foreign debt should be monitored throughout the year.

10. Interest free debt, even if it is from non-arm's length sources, does not count as foreign debt in terms of section 159GZF. Debts will not be interest free if, having regard to the amounts outstanding at a particular time, it can be said that "interest is or may become payable" in terms of section 159GZF

in respect of amounts owing at that particular time. The phrase "where interest is or may become payable" used in section 159GZF will be interpreted to apply "in respect of an amount presently owing". Debts that are within a period for which interest can never be charged are not debts for which "interest is or may become payable". When any interest-free period (common on trade debts) ceases it will be taken that "interest is or may become payable" from the end of the interest free period.

11. This type of credit agreement is to be distinguished from a credit agreement where the terms specify that no interest is payable if the debt is repaid by a specified date, but if the debt is not paid by that date interest will accrue from the date the debt was originally incurred. In the case of this latter type of agreement it will be taken that "interest may become payable" from the date the debt was first incurred because interest may be payable on the debt outstanding at the date the debt was first incurred. Where it is not apparent at a particular time whether interest will or will not be charged in respect of that period the debt will be treated as one for which "interest is or may become payable".

FOREIGN EQUITY

12. Separate definitions of "foreign equity" for resident companies, partnerships, trust estates, and foreign investors are found in section 159GZG. The definition of equity for resident companies is based on the shareholders' funds concept found in company accounting. For partnerships and trust estates the definition is based on the concepts of proprietor's capital and corpus respectively. In each instance only direct equity of a foreign controller or of a foreign investor will be measured. However, special rules for measuring indirect interests through interposed partnerships and trusts are contained in section 159GZN.

Indirect beneficial entitlements or interests - section 159GZH

13. Section 159GZH enables indirect beneficial entitlements to capital or income to be traced through a chain of companies, partnerships or trusts. The test for establishing whether foreign control exists for a company makes reference in subparagraph 159GZE(1)(a)(ii) to persons who are indirectly "beneficially entitled" to capital or income distributions. Section 159GZH defines and expands the meaning of indirect beneficial entitlements.

14. The question has been raised as to whether section 159GZH also applies to extend the definition of foreign equity in section 159GZG to enable indirect beneficial entitlements to accumulated profits, asset revaluation reserves and share premiums of subsidiary companies to be counted as foreign equity of an onshore holding company. Subsection 159GZG(1) refers to persons being "beneficially entitled" but makes no reference to any indirect beneficial entitlements. Accordingly, section 159GZH does not operate to expand the meaning of foreign equity

in section 159GZG. The latter section only counts the direct equity of foreign controllers in their Australian investments.

Equity loans-back - section 159GZG

15. In calculating the foreign equity of companies, partnerships, trusts and foreign investors under section 159GZG any amount owing at the end of the year of income to foreign controllers and their non-resident associates reduces the foreign equity of the entity. This provision ensures that funds invested as equity by foreign controllers or their non-resident associates are not lent back to them. In the absence of a control of this kind foreign equity could be artificially inflated.

16. Because debt and equity invested in an enterprise become mixed with profits and other funds it is generally not possible to identify amounts lent by an Australian enterprise to foreign controllers or their non-resident associates as being sourced in profits, debt or equity. Accordingly, all amounts owed at the end of the year of income by foreign controllers and their non-resident associates to resident companies, partnerships and trusts are deducted from the foreign equity of the relevant Australian enterprise. These equity loans-back may include trade debts, whether or not interest bearing, and amounts invested by the Australian enterprise with foreign controllers and their non-resident associates.

17. This provision necessarily has a broad operation but taxpayers can minimise the effect by ensuring that the amounts owing by foreign controllers and their non-resident associates are not allowed to build up to abnormal levels at the end of the year of income.

Measurement of equity in accordance with accounting standards

18. Where the calculation of equity for the purposes of the thin capitalisation rules would be affected by compliance with an Approved Accounting Standard, taxpayers are required to comply with that standard in calculating their equity. An example of such a standard is ASRB1013 - Accounting for Goodwill (gazetted 18 April 1988) which requires goodwill purchased by a company to be systematically amortised to the profit and loss account over a period not exceeding 20 years. As compliance with these ASRB standards is compulsory under the Companies Code it is expected that taxpayers will already be complying with them. Accordingly, thin capitalisation measurement of the profit and loss component of equity of companies and of the equity of other entities will be based on an assumption of compliance with the relevant ASRB standards.

Equity of trusts

19. To calculate the equity of a trust that has foreign beneficiaries the trustee is to use the appropriate methods of valuation of trust assets consistent with the nature of the trust. In the case of a family trust the historical cost basis

will normally be used. Where, however, the trust has substantial investments or is engaged in trading activities it may be appropriate for the trustee to revalue the trust assets and to reflect the revaluation in the accounts.

MEASUREMENT OF DEBT AND EQUITY

Trusts

20. Subsection 159GZG(4) requires a calculation of the beneficiaries' equity to be made to enable the calculation of the foreign equity of a trust estate.

21. A foreign controller who has the beneficial entitlement to units in a unit trust is able to increase the foreign equity of the trust by taking up additional units during a year of income. The question has arisen as to how foreign equity in a fixed or discretionary trust may be increased.

22. The foreign equity of a fixed or discretionary trust is to be limited to a foreign controller's irrevocable interest in the corpus of the trust. Where the trust deed so permits, the beneficiary may contribute additional corpus during a year of income, thereby increasing the level of foreign equity.

Valuation of equity and debt

23. Where loans are denominated in a currency other than the Australian dollar, foreign debt is to be measured using the historical exchange rate on the date that the funds are drawn down. In the absence of evidence to the contrary, it is to be assumed that debts are repaid in the same order as they were drawn.

24. Foreign equity on the other hand is largely measured by reference to balance sheet figures which are generally required to reflect exchange gains and losses during the year. Movements in foreign currency loans will thereby be reflected in foreign equity but not foreign debt.

Variation of equity product factor

25. Section 159GZM causes adjustments to be made in appropriate cases to the factor used to calculate the foreign equity product, either upwards from three or downwards from six. The adjusted foreign equity product will then reflect the extent to which, in a given financial year, the equity of a foreign controller is ultimately invested in financial institutions as opposed to other investments. The example in Appendix B, in addition to those contained in the Explanatory Memorandum, explains the operation of this provision in various circumstances.

Greatest foreign debt and foreign equity product

26. When calculating, for the purposes of Subdivision C, the greatest total foreign debt or the foreign equity product,

taxpayers are to combine the foreign debt and foreign equity, respectively, from all foreign controllers and their non-resident associates. For example, a taxpayer who has three foreign controllers (and/or non-resident associates) would, throughout the year, add the foreign debts from those three foreign controllers (or non-resident associates) to establish the greatest total foreign debt for the year. Similarly, the equity each foreign controller has in the taxpayer would be totalled when establishing the foreign equity product for the taxpayer.

27. For example, assume an entity with a permissible ratio of 3:1 has two foreign controllers which have invested foreign equity and debt as follows:

	Debt	Equity
Foreign Controller 1	\$5m	\$nil
Foreign Controller 2	\$1m	\$2m
TOTAL	\$6m	\$2m

Although the debt/equity ratio would be exceeded by the investment by Foreign Controller 1, no deduction would be disallowed because the ratio is satisfied when the investments from both foreign controllers are totalled.

PART-YEAR APPLICATION OF DIVISION 16F

28. Section 159GZR provides for a part-year application of the Division to modify its impact where there has been a foreign controller for only part of the year of income or where there are different (unrelated) foreign controllers during separate parts of the year. This section will not be applied where the change of ownership arises from the transfer of shares or other assets between associates as defined by section 159GZC. Nor will section 159GZR apply where the change of ownership arises under a scheme involving such associates.

RESIDENT GROUPS

29. When determining whether two companies are resident group companies for the purpose of this Division, section 159GZI requires that only shareholdings by resident companies may be taken into account. It follows that only one company in a resident company group will have any foreign equity. In addition subsidiaries of a first onshore company that are not 100% subsidiaries cannot form part of a resident company group.

30. Companies that are resident group companies are able to combine the total foreign debt of the group and deduct from that amount the foreign equity product of the member that has foreign equity when calculating the amount of the foreign debt interest that is deductible. Only one member of the group will have foreign equity as all of its subsidiaries are 100% owned subsidiaries.

Resident groups - measurement of equity

31. In a resident company group where the value of a subsidiary company increases, that increase can be reflected in the equity of the head company by making use of the asset revaluation reserve provisions. This is done by revaluation of the head company's investment in the subsidiary company. The benefit of this reflection of the true value of assets of the group will be received in the year following the revaluation because asset revaluation reserves of companies are measured for the purpose of foreign equity at the beginning of the year of income.

Resident groups - section 159GZS not to be applied

32. It has been suggested that sections 159GZS and 159GZT could be interpreted in a way that requires members of a resident company group to comply with both sections thereby reducing the allowable deduction twice. The Explanatory Memorandum on page 92 makes it clear that section 159GZS does not apply to companies that are members of a resident company group as defined by section 159GZI. Companies within such groups are not subject to the provisions of section 159GZS but are subject only to the provisions of section 159GZT.

AUSTRALIAN-OWNED NON-RESIDENT COMPANIES

33. Section 159GZD deems a non-resident company to be an Australian-owned non-resident where a resident satisfies the ownership and control tests contained in subsections (a) and (b).

34. For the purposes of the section non-resident companies are able to aggregate the interests held by Australian residents when determining if the non-resident company satisfies those tests.

COMMISSIONER OF TAXATION
16 June 1988

APPENDIX

APPENDIX A

Appendix A is issued separately

APPENDIX B

OVERSEAS	//////////////////// /FOREIGN CONTROLLER/ ////////////////////	
.....		
AUSTRALIA	////////////////////	
	/ \$1.0m	/ \$2.0m
////////////////////		////////////////////
/Company A 4.32 /		/Company B 4.14 /
/financial inst. /		/ financial inst./
////////////////////		////////////////////
/		/ \$1.5m
////////////////////		////////////////////
/		/Company C 3.52 /

/ \$0.7m	/ other investment /
/	//////////
/	/
/	//////////
/ \$0.3m	/ \$1.0m
//////////	//////////
/ Company D 3.60 /	/ Company E 3.60 /
/ other investment /	/ financial inst. /
//////////	//////////
/ \$0.2m	/ \$0.8m
//////////	//////////
/ Company G 6.00 /	/ Company F 3.00 /
/ financial inst. /	/ other investment /
//////////	//////////

The amounts shown on lines connecting companies is the net amount of equity that the higher company has in the lower. The number shown beside each company name is the factor for use in calculating the foreign equity product.

Calculations for establishing the factor are as follows:

Company G: Factor is 6 as it is a financial institution.

Company F: Factor is 3 as it is an other investment.

Company E: Factor would prima facie be 6 but it is reduced because a proportion of the foreign equity is ultimately invested in F, another investment.

Let: a = the equity passed to the subsidiary
b = the equity introduced by E's parent
c = the factor of the subsidiary

$$\begin{aligned}
 \text{Factor} &= 6 - (a/b \times < 6 - c >) \\
 &= 6 - (0.8/1 \times < 6 - 3 >) \\
 &= 6 - 2.4 \\
 &= 3.6
 \end{aligned}$$

Company D: Factor would prima facie be 3 but it is increased because a proportion of the foreign equity is ultimately invested in G, a financial institution.

$$\begin{aligned}
 \text{Factor} &= 3 + (a/b \times < c - 3 >) \\
 &= 3 + (0.2/1 \times < 6 - 3 >) \\
 &= 3 + 0.6 \\
 &= 3.6
 \end{aligned}$$

Company C: Factor is increased from 3 in the following manner:

$$\begin{aligned}
 \text{Factor} &= 3 + (\text{increase due to D}) + (\text{increase due to E}) \\
 &= 3 + (0.3/1.5 \times < 3.6 - 3 >) + (1/1.5 \times < 3.6 - 3 >) \\
 &= 3 + 0.12 + 0.4 \\
 &= 3.52
 \end{aligned}$$

Company B: Factor is reduced from 6 as follows:

$$\begin{aligned}
 \text{Factor} &= 6 - (1.5/2 \times < 6 - 3.52 >) \\
 &= 6 - (0.75 \times 2.48) \\
 &= 6 - 1.86 \\
 &= 4.14
 \end{aligned}$$

Company A: Factor is reduced from 6 as follows:

$$\begin{aligned}
 \text{Factor} &= 6 - (0.7/1 \times < 6 - 3.6 >) \\
 &= 6 - (0.7 \times 2.4) \\
 &= 6 - 1.68
 \end{aligned}$$

$$= 4.32$$