

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 ?

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

! On 8 April 2024, the *Treasury Law Amendment (Making Multinationals Pay Their Fair Share - Integrity and Transparency) Act 2024* was enacted. The amendments apply to assessments for income years commencing on or after 1 July 2023, with the exception of new integrity rules (debt deduction creation rules) which apply in relation to assessments for income years starting on or after 1 July 2024.

Under the new thin capitalisation rules:

- the newly classified 'general class investors' will be subject to one of 3 new tests
 - o fixed ratio test
 - o group ratio test
 - o third party debt test
- financial entities will continue to be subject to the existing safe harbour test and worldwide gearing test or may choose the new third party debt test
- ADIs will continue to be subject to the previous thin capitalisation rules
- the arm's length debt test has been removed for all taxpayers.

ADIs, securitisation vehicles and certain special purpose entities are excluded from the debt deduction creation rules.

Entities that are Australian plantation forestry entities are excluded from the new rules. For these entities, the previous rules will continue to apply.



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*?

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📌 Relying on this Ruling

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

Further, if we think that this Ruling disadvantages you, we may apply the law in a way that is more favourable to you.

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) costs of tax advisory services giving rise to or in connection with the debt capital, including, but not limited to, drafting of agreements, and valuing for and/or pricing of the debt capital⁵
 - (b) establishment fees
 - (c) fees for restructuring a transaction
 - (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
 - (g) costs to maintain the right to draw down funds, and
 - (h) any costs considered to be borrowing expenses under section 25-25 of the ITAA 1997 or former section 67 of the *Income Tax Assessment Act 1936* (ITAA 1936).
4. The Commissioner considers all deductible costs of raising finance through debt capital, incurred directly in connection with the debt capital⁶, and all deductible costs directly incurred in maintaining the financial benefit received in association with the debt capital⁷, 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 connection with the scheme giving rise to the debt interest.

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

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.

⁵ For completeness, the Commissioner does not consider the following costs to be debt deductions: costs of accounting for the debt capital on an ongoing basis, tax return preparation costs, and other post implementation business costs that do not directly relate to the maintenance of the finance.

⁶ See paragraph 1.59 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 (EM).

⁷ See paragraph 1.60 of the EM.

5. If a non-ADI entity's debt capital gives rise to debt deductions in any income year, then the entity shall include the average value of the debt capital, in its adjusted average debt, in accordance with the method statements for calculating adjusted average debt.⁸

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), considered to be debt interests as defined under Subdivision 974-B, 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.*

Date of effect

8. This Determination applies to years of income commencing both before and after its date of issue. However, this 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 this Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation

17 July 2019

⁸ See for example, subsections 820-85(3) and 820-185(3).

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the 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.⁹

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; and¹⁰
- (b) the entity can, apart from this Division, deduct the cost from its assessable income for that year.'

⁹ Paragraph 1.6 of the EM.

¹⁰ To date, there are no regulations for the purposes of subparagraph 820-40(1)(a)(iv).

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.

Costs 'directly incurred' in subparagraph 820-40(1)(a)(iii)

16. Paragraphs 1.59 and 1.60 of 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. The Commissioner considers that the cost of receiving the funds, such as borrowing 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'*.

¹¹ Paragraph 820-40(1)(c) formerly read: '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 ITAA 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*.

20. Further, regarding this subparagraph, the Commissioner considers that the underlying principle is a factual enquiry into whether the cost or costs, relevantly apportioned, has a close and direct connection with the objects of the expenditure – which can be either obtaining or maintaining the financial benefits received, or to be received. Accordingly, the same type of cost might be said to be debt deductions for one entity under the subparagraph, but not for another entity. This is so because the relevant factual enquiry is based on the entity's specific facts and circumstances.

References

Previous draft:

TD 2018/D5

Related Rulings/Determinations:

TR 2006/10

Legislative references:

- IITAA 1936
- ITAA 1936 former section 67
- ITAA 1997
- ITAA 1997 25-25
- 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

ATO references

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