

DISCUSSION PAPER

THIN CAPITALISATION: APPLICATION OF ACCOUNTING STANDARDS

November 2006

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Overview

On 24 January 2005, the Treasurer announced a three-year transitional period in respect of the application of Australian equivalents to International Financial Reporting Standards (AIFRS) under the thin capitalisation rules in Division 820 of the Income Tax Assessment Act 1997. During this time, entities may elect, on an annual basis, to use either AIFRS or Australian Generally Accepted Accounting Principles (AGAAP) to calculate their thin capitalisation position.

In making this announcement, the Treasurer indicated that the Government would examine whether the existing thin capitalisation rules were appropriate following the adoption of AIFRS.

The thin capitalisation rules are a key tax system integrity measure, in an environment of increasing international operations by Australian resident companies. It is important these rules operate effectively and appropriately.

The purpose of this paper is to raise awareness of the interaction between the adoption of AIFRS and the thin capitalisation rules, and suggest possible responses to the issues identified. In particular, comment is sought on:

- the nature and scale of the impact on thin capitalisation positions expected from the application of AIFRS, including an indication of which standards are causing the impact, the size of any adjustment to thin capitalisation positions and, where relevant, if that adjustment might result in the denial of tax deductions;
- the implications of retaining the thin capitalisation rules in their current form upon expiration of the transitional period; and
- possible options to mitigate identified adverse effects of AIFRS in determining an entity's thin capitalisation position.
 - Several options are identified in the paper, but should not be regarded as an exhaustive list.

In determining a preferred course of action to be recommended to the Government, Treasury is interested in the views of practitioners and industry on the various options in terms of administrative complexity, impacts on the operations and investment decisions of entities subject to thin capitalisation rules, broader economic and community impacts, implications for tax system integrity and associated risks to revenue, equity issues and implications for international integration.

Any information received that is not already in the public domain will be treated in confidence (unless advised otherwise). Any future reporting of this information would be on an aggregate basis and would not identify individual entities.

While further consultation will occur in relation to this issue as the Government's policy position is implemented, it is in the interests of those entities that are potentially adversely impacted to put forward their views to the Treasury if they have not already done so.

Comments must be received by the close of business on Friday 8 December 2006, and should be e-mailed to thincap@treasury.gov.au.

Alternatively, comments can be mailed or faxed to:

Ms Jo Laduzko
Manager, International Tax Unit
International Tax & Treaties Division
The Treasury
Langton Crescent
PARKES ACT 2600

Fax: 02 6263 4352

Inquiries regarding the paper should be directed to Dave Maher in the International Tax Unit (phone 02 6263 3152 or e-mail dmaher@treasury.gov.au).

Australia's thin capitalisation rules

The thin capitalisation regime in Division 820 of the *Income Tax Assessment Act 1997* is designed to ensure that Australian and foreign-owned multi-national entities do not allocate an excessive amount of debt to their Australian operations. It operates to disallow a proportion of otherwise deductible finance expenses (e.g. interest payments) where the debt used to fund the Australian operations exceeds certain thresholds.

These rules are regarded as a key element in maintaining the integrity of the tax base, to safeguard the intended and appropriate collection of tax by Australia in relation to international income flows involving Australian resident taxpayers. They recognise that the relevant domestic income tax arrangements introduce an incentive to use debt over equity for financing investment and business activity, and to maximise debt deductions in Australia.

The rules establish a gearing threshold beyond which an entity will be subject to the denial of debt deductions. This threshold does not represent an absolute constraint. Entities can maintain higher gearing ratios where they are prepared to forgo debt deductions for that proportion of their debt in excess of the statutory gearing limits.

How do the rules operate?

The thin capitalisation rules apply to:

- foreign entities that carry on business at or through Australian branches;
- foreign entities with direct investments within Australia (e.g. land and buildings);

- Australian entities that are foreign controlled;
- Australian controllers of foreign entities; and
- Australian entities that carry on business at or through overseas branches.

Certain associates of the abovementioned entities are also subject to the rules.

Whether an entity's debt funding is excessive or not is determined by comparing the amount of debt (or equity, in the case of Authorised Deposit-taking Institutions (ADIs)¹) used to finance the Australian business or investment with the maximum allowable amount of debt (or minimum equity requirement) specified in the legislation. This comparison is often referred to as an entity's thin capitalisation 'position'.

The proportion of an entity's debt deductions that are disallowed is the entity's excess debt (or equity capital shortfall) as a proportion of its total debt. The aim of calculating the disallowed deductions in this manner is to achieve the same level of taxable income as would have been the case had the entity's debt funding been within the prescribed limits.

Subject to the qualification mentioned below, an entity may calculate its thin capitalisation position using various tests:

- the 'safe harbour' test;
- the 'arm's length' test; and
- the 'worldwide gearing' test.

All of these tests are available to Australian resident entities that control a foreign entity or carry on business at or through an overseas branch, as well as Australian associates of such entities (known as 'outward investing' entities). However, the worldwide gearing test is not available to foreign controlled Australian resident entities, and foreign entities that carry on business at or through an Australian branch, or have direct investments in Australia (known as 'inward investing' entities).

The overwhelming majority of entities subject to the thin capitalisation rules adopt the safe harbour test, although an entity may use whichever test (e.g. the arm's length test or the worldwide gearing test, if available) provides it the greatest allowable debt.

The safe harbour test involves calculating the amount of debt as a ratio to the average value of the entity's Australian assets, with some adjustments for non-financial entities. This ratio cannot exceed three quarters of the average value of the entity's Australian assets – the so called 3:1 ratio.

¹ Under Subdivision 820-EA, non-ADI financial entities may choose to be treated as ADIs, subject to certain conditions.

In the case of ADIs, the safe harbour test essentially requires the maintenance of a minimum level of capital equal to four per cent of risk-weighted assets of the Australian banking business, as calculated under prudential standards.

The arm's length test involves an analysis of the entity's activities and funding to determine a notional amount that represents what would reasonably be expected to have been the entity's maximum debt funding (or minimum capital funding in the case of ADIs) of its Australian business through the relevant period. It is assumed for the purposes of the arm's length test that the entity's Australian operations are financed on arm's length terms.

The worldwide gearing test allows an Australian entity (other than one controlled by foreign entities) with foreign investments to fund its Australian investments with gearing up to 120 per cent of the gearing of the worldwide group that it controls. In the case of ADIs, the test allows funding of Australian investments with a minimum capital ratio equal to 80 per cent of the Tier 1 capital ratio of the worldwide group.

Use of accounting standards under the thin capitalisation rules

The recognition and valuation of assets, liabilities and equity capital is a key component of the thin capitalisation provisions. These values impact directly on whether the prescribed debt limits or minimum capital requirements have been breached and, if so, the amount of debt deduction disallowed.

The Review of Business Taxation (commissioned by the Government in 1998) considered it appropriate to have regard to accounting principles in the development of taxation legislation. In view of this, it was decided that the recognition and valuation of assets, liabilities and equity capital for thin capitalisation purposes would be conducted in accordance with applicable accounting standards (issued by the Australian Accounting Standards Board).

The use of accounting standards in determining values under the thin capitalisation rules was expected to reduce compliance costs for most entities, as the tax values are more closely aligned with accounting principles and practice, and it is generally not necessary to make separate valuations for thin capitalisation purposes.

The requirement to use accounting standards for thin capitalisation purposes has effect even if the accounting standards would not otherwise apply to an entity. Although this initially may have increased compliance costs for some entities, overall the use of accounting standards provides a reliable, consistent and transparent method to make valuations, giving greater certainty to entities in applying the rules.

Asset revaluation is provided for, but must occur in accordance with the relevant accounting standard.

At the time the thin capitalisation rules commenced in 2001, the relevant accounting standards were AGAAP. From 1 January 2005, AGAAP were replaced by AIFRS.

Why were AIFRS adopted?

AIFRS are expected to generate significant benefits for the Australian economy in the long term.

Globally accepted standards reduce the complexity for investors when making investment decisions by facilitating comparisons of cross-jurisdictional financial information. The standards reduce compliance costs for preparers of financial information who are required to report on company operations in more than one jurisdiction.

International Financial Reporting Standards (IFRS) have been adopted in a large number of overseas countries, particularly in Europe. While some countries have not adopted IFRS, the most notable of these – the United States – is currently examining the extent to which its accounting standards can be harmonised with IFRS.

The standards also fill a number of gaps in the Australian financial reporting framework, in particular in relation to financial instruments and intangible assets.

Overall, it is expected that widespread adoption of IFRS will result in greater confidence in the market, facilitate greater cross border investment and promote the integration of global financial markets.²

Implication of the change in accounting standards

The adoption of AIFRS for thin capitalisation purposes was an automatic outcome of the current law. The thin capitalisation rules implicitly recognised and provided for the likelihood of changes to underlying accounting standards, and were drafted to provide for a seamless integration of such changes.

There are clear benefits associated with valuations for thin capitalisation purposes being determined by reference to these standards.

- AIFRS are comprehensive, transparent and objective (although it is acknowledged that some standards are not finally settled).
- It reduces compliance costs for entities subject to the thin capitalisation rules, as the same set of accounts will satisfy both their corporate reporting and thin capitalisation requirements.

² These sentiments were expressed in the Government's Corporate Law Economic Reform Program Proposals for Reform Paper No.1 *Accounting Standards: Building international opportunities for Australian Business* (1997), and endorsed by the Financial Reporting Council (see for example the Council's Bulletin 2002/4 dated 3 July 2002).

- As an adoption (albeit with some modifications) of standards operating in many overseas countries, it improves comparability of Australian and overseas financial reporting. In many instances, it is likely that multi-national entities subject to Australia's thin capitalisation rules will also operate in countries which have adopted IFRS.

However, AIFRS create standards on matters that were not covered under AGAAP and, in some cases, significantly change the recognition or valuation of assets, liabilities and equity capital that had applied under AGAAP.

These differences mean that some entities will have a noticeably different thin capitalisation position under AIFRS than was the case under AGAAP.

To defer the impact of these changes while consideration could be given to the nature and appropriateness of the AIFRS outcomes for thin capitalisation purposes, a three year transitional period was introduced.³ During this period an entity may elect, on an annual basis, to continue to use AGAAP. This transitional period applies to an entity from its first income year commencing on or after 1 January 2005.

A general examination of annual reports of major companies, and information provided by certain entities to the Treasury, reveals the following asset write-downs or liability increases resulting from adoption of AIFRS have occurred or are expected:

- approximately \$6 billion write-down of intangible assets (based on data from eight companies in the beverage and media sectors);
- approximately \$1.3 billion increase in deferred tax liabilities (based on data from seven companies in the beverage and media sectors); and
- approximately \$0.7 billion write-down of impaired assets (based on data from six companies in the beverage, media and mining sectors).

Submissions from, and discussions with, entities that consider the adoption of AIFRS will adversely affect their thin capitalisation position indicate that the following standards are causing particular concern:

AASB 138 Accounting for intangible assets

This standard represents a significant change from the previous AGAAP (AASB 1041 Revaluation of Non-Current Assets). In particular, AASB 138 requires entities to value acquired intangible assets at their original cost. Revaluation of acquired intangible assets is only permitted where the revaluation is made with reference to an active market. Such markets rarely exist for intangibles. Most internally generated intangible assets are not recognised at all under AASB 138.

³ The transitional arrangements are set out in section 820-45 of the *Income Tax (Transitional Provisions) Act 1997*.

In contrast, AASB 1041 allowed for the recognition of internally generated intangible assets, and permitted both internally generated and acquired intangibles to be revalued without reference to an active market, so long as valuations were kept up to date.

AASB 112 Income taxes

This standard uses a balance sheet approach to calculate deferred tax balances (as opposed to AGAAP's use of an income statement method, which focussed on movements rather than closing balances). Under the new standard the amount of deferred tax balances (both assets and liabilities) may increase.

AASB 136 Impairment of assets

The impairment test under the new standard is more rigorous than under the previous standard (AASB 1010). In particular, the recoverable amount of an asset is now the higher of its 'value in use' or its fair value, less cost to sell. Discounted cash flow must be used to calculate the recoverable amount – this was not required under the previous standard, and asset values could be reduced as a result.

AASB 139 Financial instruments – recognition & measurement

Under this standard the classification of certain convertible financial instruments is changed. In addition, all financial assets and liabilities, including derivatives, will have to be recognised on balance sheet. This has the potential to increase the volatility of asset and liability values.

Question 1 for consultation: *The above accounting standards have been identified as the standards most directly impacting on the operation of the thin capitalisation rules. Are there any other standards causing concern?*

Post-transitional period arrangements

The current law provides that following cessation of the transitional period those entities subject to the thin capitalisation rules will be required to use AIFRS to calculate their debt to equity position.

Not all entities will be adversely impacted in terms of their thin capitalisation position with the application of AIFRS, as for many there will be no significant change in the recognition or valuation of their underlying assets, liabilities and equity capital.

While there is currently incomplete data as to how many entities have elected to continue using AGAAP under the transitional arrangements, there is some evidence that a number of entities have chosen to adopt AIFRS.

These entities will be advantaged by being able to use AIFRS for thin capitalisation purposes, consistent with their general accounting obligations.

However, some entities will clearly experience a deterioration in their thin capitalisation position, either through a reduction in the value of assets and/or an increase in liabilities that feed into their thin capitalisation calculations.

For a small number of these entities, this will result in the thin capitalisation 'buffer' they had under AGAAP being converted to a thin capitalisation deficit under AIFRS, resulting in the denial of a portion of their debt deductions. This, in turn, would nominally increase their tax payable. Further, a change in the amount of debt they could carry relative to their asset levels before deductions are denied may impact on their future decision-making in terms of levels of investment (acquisition or expansion) and choice of financing.

In such circumstances those entities that wish to avoid having debt deductions denied would need to:

- restructure their balance sheet (for example, by issuing more capital and/or reducing debt levels); and/or
- avail themselves of the arm's length or the world-wide gearing tests.

Comments have been received, however, to suggest that the other tests are either not available or are impracticable (providing insufficient certainty on which to base future investment decisions).

Are the thin capitalisation rules appropriate?

In providing the transitional arrangements, it was recognised that the adoption of international accounting standards would impact on entities' compliance with thin capitalisation rules and that some time was required to evaluate what, if any, changes may be appropriate.

However, the adoption of AIFRS was not considered as requiring a fundamental reform of the existing thin capitalisation regime. The policy underpinning the thin capitalisation rules is not driven by accounting standards or changes in direction taken in AIFRS. Moreover, accounting standards are merely a mechanism for undertaking valuations for the purposes of the thin capitalisation rules. As previously noted, alignment of accounting standards for corporate reporting purposes and for use in thin capitalisation calculations was considered to benefit business through reducing compliance costs.

The thin capitalisation rules were introduced in 2001 following extensive and careful industry consultation. The use of accounting standards was supported by industry at the time, and not identified as raising in-principle difficulties. Further amendments were made to clarify the application of accounting standards in 2003, again with strong industry support.

However, the valuation of assets, liabilities and equity capital is an important element of the thin capitalisation rules (especially in relation to the safe harbour test) and the move to AIFRS has clearly impacted on some valuations.

Consequently, it is relevant to examine whether the current basis for these valuations remains appropriate, including whether they produce unreasonable outcomes for certain entities subject to the rules.

This should include consideration as to whether this is a matter that:

- (i) requires an appropriate grandfathering arrangement, noting that existing thin capitalisation reporting entities were effectively subject to an arbitrary change, the impacts of which they should be sheltered from; or
- (ii) reflects an outcome that warrants a solution that benefits current and future thin capitalisation reporting entities.

Possible options for changes to the thin capitalisation rules in light of the adoption of AIFRS would seem to fall into two main categories:

- those which focus primarily on the safe harbour test, and involve departures from AIFRS in the recognition and/or valuation of certain assets, liabilities or equity capital; and
- changes to the arm's length test to make it a more attractive alternative to the safe harbour test for those entities that would be adversely impacted by the adoption of AIFRS.

Departures from AIFRS

This approach canvasses various options for adjustments to the current valuation methodology, all of which involve departing from AIFRS to a greater or lesser degree. While such changes may introduce some complexity, it is understood that these options are technically possible.

Option 1: continue the choice to apply all AGAAP for a further limited period or indefinitely

This option would allow entities that feel they are currently disadvantaged under AIFRS in terms of their thin capitalisation position to continue to apply AGAAP. This would remove the need for them to make any adjustments to avoid the denial of tax deductions and/or maintain their current thin capitalisation buffer.

This outcome is obviously dependent on whether or not the choice of using AGAAP was limited to a specific period or not.

However, this approach would require stakeholders to maintain familiarity and expertise with redundant accounting standards. It would also perpetuate complexity in the thin capitalisation rules through having two sets of standards applying to the recognition and valuation of assets and liabilities, which is likely to add substantially to the costs of administering the rules and monitoring compliance.

The longer the AGAAP were grandfathered the longer this complexity would persist, and it is likely that the cost of maintaining expertise in superseded standards would increase over time.

Furthermore, the AGAAP recognition and valuation methodologies would remain fixed (given they have been superseded by AIFRS) and would not cater for new or emerging issues or developments in such methodologies.

This could result in considerable churn as entities switch between standards to achieve the best thin capitalisation outcome, irrespective of whether they were initially affected by the switch to AIFRS. This raises the question of whether in granting such an option, an entity should be permitted to elect the methodology it intended to use once only, or on an annual basis?

On a more fundamental level, the continued use of AGAAP would result in the continuation of a range of valuation approaches that Australia no longer endorses for other reporting purposes. Consequently, this option does raise a number of difficulties that do not appear to be outweighed by any intrinsic justification for this approach.

Question 2 for consultation: *How effective would this option be in addressing industry concerns and would such an approach be sustainable given the difficulties mentioned in the description above? What modifications to this option could be adopted to address such difficulties?*

Restrict to particular elements of AGAAP

This option could be limited to providing for the continued use of only those AGAAP standards for which the AIFRS equivalent is currently causing the greatest adverse impact on entities' thin capitalisation positions.

This would address the current issue in a more targeted manner, although there is a risk that not all relevant standards would be identified through consultation. Otherwise, the same issues would seem to arise as discussed above.

The majority of entities that have indicated to the Government that they will be impacted by AIFRS have identified the standard relating to intangibles assets (AASB 138) as their main concern, with lesser concern being expressed about other standards, such as those relating to financial instruments, income taxes and impairment of assets. If this is an accurate picture of the overall impact of AIFRS, it should be possible to substantially reduce the number of entities that would be adversely affected if AIFRS was adopted by grandfathering relatively few AGAAP.

Option 2: Allow for departure from accounting standards in the recognition and/or valuation of certain specified assets and liabilities

This option would not involve any grandfathering of the AGAAP standards, but would allow entities to recognise and/or establish their own valuation of certain assets or liabilities for thin capitalisation purposes, where those assets and liabilities would not be recognised or would be given a different value under AIFRS – examples would be intangible assets, or assets/liabilities whose carrying value experiences volatility.

The integrity of asset (re)valuations is a critical element to the effectiveness of the thin capitalisation arrangements. The criteria applying to valuations made other than in accordance with accounting standards would need to be prescribed to ensure their reliability, verifiability and objectivity.

This approach also implies that (re)valuations would need to be validated by an independent expert, supported by detailed record keeping requirements. Internally generated valuations that are not independently validated would not be acceptable.

Given the possible absence of an active reference market for certain assets, considerable consultation would need to be undertaken around the development of a 'fair value' for certain assets.

This option would arguably increase the complexity of the legislation, in that some assets and liabilities would be recognised and/or valued on different bases to those contained in accounting standards, while the remaining assets and liabilities would be recognised and/or valued using the methodology of the accounting standards.

There would also be costs for those entities wishing to use this option, associated with obtaining valuations and demonstrating they were reasonable.

However, a limited departure from the use of accounting standards to determine thin capitalisation positions, as envisaged under this option, would provide for an objective valuation of certain assets and liabilities that would enable entities otherwise substantially impacted by the adoption of AIFRS to stay within thin capitalisation thresholds.

Question 3 for consultation: *Does this option provide an effective approach to address concerns about the interaction of AIFRS with the thin capitalisation rules? Can this proposal be implemented without introducing unwarranted additional complexity into the thin capitalisation rules?*

Option 3: Abandon the use of accounting standards for the recognition and valuation of assets and liabilities for thin capitalisation purposes

This option would sever the link between accounting standards and the thin capitalisation rules completely, and is likely to involve substantial change to the legislation. More generally, it would be a departure from the trend towards the greater use of accounting standards and methodologies in taxation legislation.

Assets and liabilities that would be recognised for thin capitalisation purposes would have to be comprehensively defined, and there would need to be prescription of the methodologies for valuing those assets and liabilities. While this may provide entities subject to the rules with a high degree of certainty in relation to valuations, it is likely to require development of substantial additional guidance to taxpayers.

To the extent that definitions in the legislation replicate those in accounting standards, it would represent unnecessary duplication. To the extent the definitions diverge from those in accounting standards, it would mean that two sets of definitions would exist – one for general accounting purposes and one specifically for thin capitalisation purposes.

It is also likely that the legislation would need updating as new issues or interpretations arise, compounding the costs of incorporating prescriptive definitions within the legislation. Consequently, the definitions prescribed in the law may be less flexible than those referenced from other sources.

Question 4 for consultation: *How effective is this approach in addressing industry concerns? Is it likely to result in greater certainty for taxpayers and can it be implemented without introducing significant complexity into the thin capitalisation regime?*

Amend the arm's length test

The arm's length test is an alternative to the safe harbour and worldwide gearing tests that entities may use to determine their thin capitalisation position, and relies less directly on the use of accounting standards to calculate asset and liability values.

The test takes account of the business activities and operating environment of individual entities, and is capable of giving more emphasis to factors such as cash flow, which it is argued is of greater relevance to lending institutions than balance sheet values when making lending decisions.

This would be significant for those entities carrying assets that do not have an obvious active market against which to reference valuations.

Currently, the test is considered by some to be too subjective and uncertain to apply effectively. This is particularly the case for those entities looking to develop an extended program of offshore acquisition or expansion.

Possible amendments to the arm's length test raised with Treasury to date (which could be implemented individually or in combination) include:

- relaxing the requirement that an entity be required to be able to have borrowed the same amount independently on exactly the same terms;
- using proxies for arm's length borrowing capacity other than the safe harbour test's net Australian assets (such as interest cover on Australian cash flows);
- extending the period of the test, such that once passed, it would not need to be applied again for three to five years or until such time as there was a material change in the circumstances of the entity;
- moving to an 'independent lender' test, relying on factors that a commercial lending institution would have regard to, such as – credit rating, cash flow (ability to service debt), and security of assets; and
- amending or removing some of the relevant factors that must be taken into account under the current test (set out in subsections 820-105(3), 820-215(3), 820-315(3) and 820-410(3)).

Any changes to the arm's length test will lead to some costs, both for taxpayers in interpreting and applying the amended test and the ATO, in issuing guidance material to assist taxpayers.

A more flexible and useable arm's length test will benefit those entities that would otherwise suffer a deterioration in their thin capitalisation position if required to adopt accounting standard methodologies for recognising and valuing assets and liabilities under the safe harbour and worldwide gearing tests. Although accounting standards are relevant to the calculation of amounts under the arm's length test, their application does not raise the same concerns as pertain to the other tests.

It would also avoid the difficulties associated with the introduction of multiple valuation methodologies into the safe harbour test.

Question 5 for consultation: *Would modifying the arm's length test as discussed above address industry concerns? Of the possible approaches mentioned which of the suggested changes to the arm's length test would provide the greatest level of tax payer certainty and minimise complexity? Are there other amendments that could be made to the arm's length test that maintain the integrity of the thin capitalisation rules yet address the impact flowing from certain AIFRS standards?*

Question 6 for consultation: *Are there other changes to the thin capitalisation rules not mentioned in this discussion paper that should be considered in the context of the application of accounting standards?*
