TREASURY LAWS AMENDMENT (MAKING SURE MULTINATIONALS PAY THEIR FAIR SHARE OF TAX IN AUSTRALIA AND OTHER MEASURES) BILL 2018

EXPOSURE DRAFT EXPLANATORY MATERIALS

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Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ADI	authorised deposit-taking institution
ITAA 1997	*Income Tax Assessment Act 1997*
ITAA 1936	*Income Tax Assessment Act 1936*

Chapter 1
Improving the integrity of the thin capitalisation rules

Outline of chapter

1.1 Schedule 1 to this Exposure Draft Bill tightens Australia's thin capitalisation rules by:

- requiring an entity to use the value of the assets and liabilities that are used in its financial statements;
- removing the ability for an entity to revalue its assets specifically for thin capitalisation purposes; and
- ensuring that non-ADI foreign controlled Australian tax consolidated groups and multiple entry consolidated groups that have foreign investments or operations are treated as both outward investing and inward investing entities.

1.2 All references in this Chapter are to provisions in the ITAA 1997 unless otherwise stated.

Context of amendments

1.3 The thin capitalisation rules apply to foreign controlled Australian entities, Australian entities that operate internationally and foreign entities that operate in Australia. These entities are classified as:

- outward investing entities;
- inward investing entities; or
- both outward and inward investing entities.

1.4 In the case of an entity that is not an ADI, the thin capitalisation rules operate to, broadly, deny a deduction for debt financing expenses to the extent that the entity's debt exceeds a prescribed level (and the entity is therefore thinly capitalised). A thin capitalisation exposure (where debt deductions are disallowed) will arise where the level of adjusted average debt exceeds the maximum allowable debt during an income year.

1.5 In the case of an entity that is an ADI, the rules operate to, broadly, deny a deduction for debt financing expenses if the ADI's minimum capital amount is not reached during an income year. A thin capitalisation exposure will arise where an entity has a capital shortfall between its adjusted average equity capital amount and its minimum capital amount.

1.6 There are a number of tests available to determine whether the entity has a thin capitalisation exposure. These rules vary depending on the thin capitalisation classification of the entity.

Asset recognition and revaluations

1.7 An entity is generally required to comply with accounting standards in:

- determining what are its assets and liabilities; and
- calculating the value of its assets, liabilities and equity capital.

1.8 However, the thin capitalisation rules allow an entity to recognise certain assets and revalue its assets in a different way in certain circumstances.

1.9 Recently, there has been a significant increase in the use of asset revaluations by taxpayers in order to generate additional debt capacity under the safe harbour debt amount. This enables these taxpayers to claim greater debt deductions. Concerns have been raised about the rigour and accuracy of some of these asset revaluations.

Classification of head companies of Australian consolidated groups

1.10 Under the thin capitalisation provisions, a head company of a consolidated group or multiple entry consolidated group is classified as an outward investing entity if it:

- is a foreign controlled non-ADI; and
- controls foreign entities or has foreign permanent establishments.

1.11 As a result, some head companies have taken advantage of certain thin capitalisation rules that are only intended for outward investing entities that are not foreign controlled Australian entities.

Summary of new law

1.12 Schedule 1 to this Exposure Draft Bill tightens Australia's thin capitalisation rules by:

- requiring an entity to use the value of the assets and liabilities that are used in its financial statements;

- removing the ability for an entity to revalue its assets specifically for thin capitalisation purposes; and
- ensuring that non-ADI foreign controlled Australian tax consolidated groups and multiple entry consolidated groups that have foreign investments or operations are treated as both outward investing and inward investing entities.

1.13 A transitional rule will allow an entity to rely on revaluations of assets supported by the entity's most recent valuation made prior to the time of announcement of the measure on 8 May 2018. These revaluations can be used until the last day before the start of the income year commencing on or after 1 July 2019.

Comparison of key features of new law and current law

New law	***Current law***
For the purpose of the thin capitalisation rules, an entity must comply with the accounting standards in determining and calculating the value of its assets, liabilities and equity capital. An entity: • must use the value of the assets and liabilities that are used in the entity's financial statements; and • can no longer revalue its assets specifically for thin capitalisation purposes. An entity can rely on revaluations of assets supported by the entity's most recent valuation made prior to the time of the announcement of the measure. These revaluations can be used until the last day before the start of the income year commencing on or after 1 July 2019.	For the purpose of the thin capitalisation rules, an entity must comply with the accounting standards in determining and calculating the value of its assets, liabilities and equity capital. An entity can depart from this value to: • value its assets at a value different to that used in the entity's financial statements; • recognise internally generated intangible assets that are not recognised under the accounting standards; and • revalue intangible assets that do not have an active market.
Non-ADI foreign controlled Australian tax consolidated groups and multiple entry consolidated groups that have foreign investments or operations will be treated as both outward investing and inward investing entities.	Non-ADI foreign controlled Australian tax consolidated groups and multiple entry consolidated groups that have foreign investments or operations are treated as outward investing entities.

Detailed explanation of new law

1.14 Schedule 1 to this Exposure Draft Bill tightens Australia's thin capitalisation rules by:

- requiring an entity to use the value of the assets and liabilities that are used in its financial statements;
- removing the ability for an entity to revalue its assets specifically for thin capitalisation purposes; and
- ensuring that non-ADI foreign controlled Australian tax consolidated groups and multiple entry consolidated groups that have foreign investments or operations are treated as both outward investing and inward investing entities.

Alignment with financial statement values

1.15 An entity must determine or calculate an asset or liability for the purposes of the thin capitalisation rules in the same way as it would determine or calculate them in their financial statements if:

- the entity is required by an Australian law to prepare financial statements for a period in accordance with the accounting standards; and
- the entity's assets or liabilities are determined or calculated in accordance with the accounting standards in the entity's financial statements for the period.

[Schedule 1, item 11, subsection 820-680(2)]

1.16 The entity must recognise the same assets and liabilities for its thin capitalisation calculations that are contained in its financial statements. In addition, the entity must calculate and measure the value of its assets and liabilities for thin capitalisation purposes in the same way as it does in its financial statements. This ensures alignment between accounting values and tax values.

1.17 If an entity prepares multiple financial statements that are in accordance with the accounting standards for the same period or have periods that overlap, then the entity must use the most recently prepared financial statements for determining or calculating its assets and liabilities for thin capitalisation purposes. ***[Schedule 1, item 11, subsection 820-680(3)]***

1.18 Under the thin capitalisation rules, an entity can choose to adopt the opening and closing averaging method for its thin capitalisation calculations. This method requires calculating the average value of the following amounts:

- the opening value of assets and liabilities on the first day of the income year; and
- the closing value of the assets and liabilities on the last day of the income year.

1.19 In this situation, the entity would use the assets and liabilities and their respective opening and closing values contained within the entity's financial statements for those periods. These periods would typically be the year end values of these assets and liabilities reflected in a prior income year financial statements (for the opening values) and the current year financial statements (for the closing values).

1.20 If an entity adopts another method for calculating average values permitted by the thin capitalisation rules, then there may be points in time throughout that income year period where the values would not be reflected in the year end financial statements.

1.21 For example, if an entity adopts the quarterly period averaging method, it may not prepare financial statements at each measurement point.

1.22 In these circumstances, an entity must determine or calculate its assets and liabilities (including its debt capital) for those quarterly periods in the same way as they are determined or calculated in the entity's financial statements.

1.23 For example, if an entity adopts a cost less depreciation accounting methodology for its asset values in its financial statements, the entity must also adopt that same accounting methodology for determining and calculating the value of those assets for each of the intervening quarterly end periods.

Example 1.1: Half year and full year financial reports

A&P Co is a company that has a 30 June year end. A&P Co is required to prepare half yearly financial statements (at 31 December) and full year financial statements (at 30 June) under an Australian law.

A&P Co recognises certain land and building assets which are reflected in its financial statements. It values these assets using a cost less depreciation accounting methodology.

For thin capitalisation purposes, A&P Co adopts the quarterly period averaging method.

For the first quarterly period (this being 30 September), A&P Co must determine and calculate the value of the land and buildings. However, the first quarterly period is not the same period as either the half yearly financial statement or the full year financial statement. The first quarterly period overlaps with the periods contained in the half yearly and full yearly financial statements.

Therefore, A&P Co must determine or calculate the value of the land and buildings in the same way as it is determined or calculated in the financial statement for the full year financial statement (at 30 June) which is the most recent of the overlapping periods.

1.24 If an entity is not required to prepare financial statements in accordance with accounting standards under an Australian law, the entity must determine and calculate its assets and liabilities in accordance with the Australian accounting standards (subsection 820-680(1)). This applies even if the Australian accounting standards do not apply to the entity (section 820-680(3)).

Removing the ability for an entity to revalue its assets

1.25 Schedule 1 to this Exposure Draft Bill repeals the following provisions:

- subsections 820-680(2) to (2E);
- section 820-683;
- section 820-684; and
- section 820-985.

[Schedule 1, items 11, 13 and 16]

1.26 The repeal of these provisions removes the ability for an entity to revalue its assets and liabilities and recognise certain intangible assets specifically for thin capitalisation purposes. Therefore, any revaluation and recognition of assets and liabilities must comply with accounting standards.

Thin capitalisation classification of head companies

1.27 Schedule 1 to this Exposure Draft Bill amends the thin capitalisation rules to remove provisions which deem the head company of a tax consolidated group or multiple entry consolidated group to be an outward investing entity only. ***[Schedule 1, items 5 and 7, subsections 820-583(5) and (6)]***

1.28 Consequently, an entity that is the head company of a tax consolidated group or a multiple entry consolidated group will be classified as both an outward and inward investing entity if the following conditions apply:

- it is foreign controlled; and
- it holds investments in a foreign entity or has a foreign permanent establishment.

1.29 Entities that are classified as both outward investing and inward investing entities are disqualified from applying certain thin capitalisation rules (for example, see sections 820-37, 820-110, 820-216 and 820-217 which are only available for outward investing entities).

Example 1.2: Head company that is both an outward investing and inward investing entity

> Kev Co is the head company of an Australian tax consolidated group. Kev Co is wholly controlled by a foreign parent and also wholly controls a foreign entity.
>
> Kev Co is both an outward investing entity and an inward investing entity.

Consequential amendments

1.30 Schedule 1 to this Exposure Draft Bill makes consequential amendments to the ITAA 1997 and ITAA 1936 to:

- remove the record keeping requirements relating to the revaluation of assets and liabilities;
- remove references to the ability for an entity to revalue its assets for the purpose of the thin capitalisation rules; and
- repeal headings and references to the repealed provisions relating to the revaluation of assets.

[Schedule 1, items 1 to 4, 6, 8 to 10, 12, 14 and 15, section 262A of the ITAA 1936, sections 820-583, 820-680, 820-682, 820-933 and 820-985]

Application and transitional provisions

Revaluation of assets and transitional rule

1.31 The amendments relating to the repeal of the provisions which enabled an entity to revalue its assets for thin capitalisation purposes for the determination and calculation of an entity's assets, liabilities and equity capital apply after 7.30 pm (by legal time in the Australian Capital Territory) on 8 May 2018 (the transition time). ***[Schedule 1, subitem 17(1)]***

1.32 A transitional rule applies for an entity that has determined or calculated its assets, liabilities and equity capital prior to the transition time. The rule will apply if:

- the revaluation of assets is supported by the entity's most recent valuation that complies with the thin capitalisation rules made prior to the transition time; and
- those revaluations can only be relied upon by the entity for income years beginning before 1 July 2019 (that is, until the

last day before the start of the income year commencing on or after 1 July 2019).

[Schedule 1, subitem 17(2)]

1.33 The value of these revalued assets will effectively be frozen at the value reflected in the entity's most recent valuation made before the transition time that is compliant with the requirements of Division 820.

1.34 In order to be compliant with Division 820, the entity must satisfy the revaluation and record-keeping requirements in Subdivisions 820-G and 820-L.

1.35 Entities relying on the transitional rule will not be required to undertake further valuations for thin capitalisation purposes.

Example 1.3: Valuation of assets for transition

Tea Co prepares financial statements under an Australian law and has a 30 June year end. Tea Co accounts for its assets using a cost less depreciation methodology in its financial statements.

Tea Co acquired an asset that cost $100 million in 2016. The asset was revalued for thin capitalisation purposes to $110 million (being its most recent valuation of the asset). This revaluation of the asset is supported by a compliant valuation that satisfies the requirements under Division 820. The valuation was completed prior to 8 May 2018.

Therefore, Tea Co can rely on the transitional rule in subitem 17(2).

The fair value of the asset at 30 June 2018 is $90 million. However, under the transitional rule, for the purposes of applying the thin capitalisation rules in the 2017-18 and 2018-19 income years, Tea Co may rely on the $110 million revaluation.

Requirement to align with financial statement values

1.36 The amendments relating to the requirement for an entity to adopt the same methodology for determining and calculating the entity's assets and liabilities as reflected in the entity's financial statements apply after the transition time. ***[Schedule 1, subitem 17(1)]***

1.37 An entity can choose to adopt the requirement to use the same methodology as reflected in the entity's financial statements, rather than rely upon the transitional rule if it wishes.

Thin capitalisation classification of head companies

1.38 The amendments to remove the deeming of a head company to be an outward investing entity applies in relation to income years beginning on or after 1 July 2019. ***[Schedule 1, item 18]***