TR 2002/D6 - Income tax: Thin Capitalisation - Definition of assets and liabilities for the purposes of Division 820

This document has been finalised by TR 2002/20.

Draft Taxation Ruling
Income tax: Thin Capitalisation-Definition of assets and liabilities for the purposes of Division 820.

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

Definition of 'assets' and 'liabilities'

1. This Ruling considers what is included in the term 'assets' in the context of the thin capitalisation rules contained in Division 820 of the *Income Tax Assessment Act 1997* ('ITAA 1997'). It also considers what is included in the term 'liabilities' for the purpose of the definition of 'non-debt liabilities' in the same thin capitalisation context. These terms are used to calculate the maximum allowable debt a non-ADI entity can have for the purpose of the safeharbour debt amount. A non-ADI entity is an entity which is not an authorised deposit-taking institution under the *Banking Act 1959*.

2. The rules applicable to ADIs for the purposes of the safeharbour capital amount and the worldwide capital amount are based upon the term 'risk-weighted assets'. This term takes its meaning from the appropriate prudential standards applicable to the ADI. This Ruling does not deal with this definition. The concept of 'non-debt liabilities' is not relevant to ADI entities.

Valuation of assets and liabilities under accounting standards

3. This Ruling also discusses the requirement under section 820-680 that an entity calculates the value (including revaluations) of its assets and liabilities, identified for the purposes of the thin capitalisation rules, in accordance with the accounting standards.

Ruling

Assets

4. In the thin capitalisation provisions the term 'assets' is not defined, and accordingly takes its ordinary meaning in law relevant to the context. In this particular context we consider that the term 'assets' for the purposes of Division 820 carries its accounting meaning. The accounting meaning is defined in Statement of Accounting Concepts 4, at paragraph 14, (SAC 4) as:

> 'future economic benefits controlled by the entity as a result of past transactions or other past events'.

Liabilities

5. The term 'liabilities' is similarly undefined in Division 820 and so takes its ordinary meaning in law relevant to the context. It is also appropriate to adopt the accounting meaning of the term 'liabilities' for the purposes of Division 820. Liabilities are also defined in SAC 4 (at paragraph 48) as:

> 'the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events'.

Valuation of assets and liabilities.

6. The values adopted for assets and liabilities, as well as the entity's debt capital and equity capital must comply with the accounting standards. The accounting standards for this purpose are the accounting standards as per the meaning in the *Corporations Act 2001*.

7. In the absence of a specific accounting standard relevant to an asset or liability in question, we consider the valuation must be in accordance with an appropriate accounting policy selected and applied as per paragraph 4 of accounting standard AASB 1001 *Accounting Policies*. We consider that conformity with the requirements of 'relevance' and 'reliability' specified in paragraph 4.1 of AASB 1001 for thin capitalisation purposes would include demonstrating that the process of selecting the accounting policy has followed the order of preference set out in the commentary in paragraph 4.1.2 of that standard.

Date of effect

8. This Ruling (and the new thin capitalisation regime) applies from the start of an entity's first year of income beginning on or after 1 July 2001.

9. It may be the case that some taxpayers have incurred substantial costs undertaking activities to identify and value assets and/or liabilities using an interpretation based upon a legalistic or jurisprudential approach to these terms, rather than upon the accounting meanings adopted in this Ruling. In consideration of these factors, and the timeframes available between the release of this Draft Ruling and the end of the year of income commencing on or after 1 July 2001, taxpayers in such circumstances may adopt that alternative meaning consistently for both assets and liabilities. Taxpayers can only adopt this alternative for the first income year commencing on or after 1 July 2001. Future income years would be expected to comply with the accounting definition of assets and liabilities.

Explanations

10. The thin capitalisation rules in Division 820 applying to non-ADI entities specify a maximum amount of debt that such an entity can have before the thin capitalisation rules are breached. If the entity's debt exceeds this maximum amount, it cannot deduct a proportion of its otherwise allowable debt deductions. The maximum allowable debt is the greatest of:

- the safe harbour debt amount (see sections 820-95, 820-100, 820-195, 820-200, 820-205, and 820-210);
- the arm's length debt amount (see sections 820-105, and 820-215); and
- the worldwide gearing debt amount (relevant to entities which are outward investing only, see section 820-110).

11. The safe harbour debt amount and the worldwide gearing debt amount calculations use, as their starting point, the average value of an entity's 'assets'. This value is then reduced by various amounts including the value of 'non-debt liabilities'. Total average assets are reduced by non-debt liabilities and other specific items to isolate the value of the entity's Australian assets upon which thin capitalisation calculations are based.

12. In the safe harbour capital amount and worldwide capital amount calculations, relevant only to ADI entities, the concept of 'risk-weighted assets' is used and is defined by reference to the

prudential standards. The notion of 'non-debt liabilities' is not relevant to this definition.

13. The term 'assets' is not defined in the ITAA 1997. The explanatory memorandum states, at paragraph 1.72, that the term is used in its 'normal, legal meaning', in other words its ordinary meaning in law relevant to this context. The *Macquarie Dictionary* (2^{nd} revised edition) gives several alternate meanings of the term 'assets' as follows:

> 1) *Comm* resources of a person or business consisting of such items as real property, machinery, inventories, notes, securities, cash etc.
>
> 2) Property or effects (opposed to *liabilities*).
>
> 3) *Accounting*, the detailed listing of property owned by a firm and money owing to it.
>
> 4) *Law*
>
> > a) property in the hands of an executor or administrator sufficient to pay the debts or legacies of the testator or intestate,
> >
> > b) any property available for paying debts, etc.

In the context of thin capitalisation it is our view that the appropriate context from which to take definitions is an accounting context, so that the term 'assets' adopts its accounting meaning. These contextual factors are discussed below at paragraphs 15-18.

14. The term 'liabilities' is used in the context of the compound phrase 'non-debt liabilities' for the purpose of the safeharbour tests. The term 'non-debt liabilities' is defined in subsection 995-1(1) ITAA 1997 as meaning:

> '…liabilities that the entity has at the time, other than:
>
> a) any *debt capital of the entity;
>
> b) any *equity interest in the entity;
>
> c) a provision for a *distribution of profit if the entity is a *corporate tax entity; or
>
> d) any liability of the entity under a securities loan arrangement if, as at that time, the entity:
>
> > (i) has received amounts for the sale of securities (other than any fees associated with the sale) under the arrangement; and
> >
> > (ii) has not repurchased the securities under the arrangement.'

> The term 'liabilities' is itself undefined in the ITAA 1997 and takes its ordinary meaning in this context.

Contextual Factors

15. The broad context in which the terms are used is a regime determining an acceptable mix of debt and equity capital for funding a business. For commercial purposes, when deciding whether to lend, and how much to lend, a commercial lender would generally turn to the entity's accounting records that detail assets and liabilities. By analogy this would also seem to be the logical basis under which a thin capitalisation analysis would be commenced as well.

16. In more specific terms, the safe harbour debt amount calculations (and the worldwide gearing debt amount calculation which is based on the safe harbour debt amount) determine the safe harbour debt/equity mix based on the entity's assets and liabilities. The calculation is broadly based on the fundamental accounting equation of assets = liabilities + equity. In thin capitalisation terms, the equation is modified by dissecting liabilities into debt liabilities and non-debt liabilities. The safe harbour debt calculation applies a fraction to a figure which represents net Australian assets funded by debt and equity. This requires all liabilities which are neither debt nor equity as defined, to be taken out of the equation in order to isolate the amount of assets funded by debt liabilities and by equity. This requires a link between asset values on the one hand and equity, debt and other liabilities on the other hand. The accounting meanings of 'assets' and 'liabilities' provide this link.

17. Furthermore, the legislation relies on the valuation rules in the accounting standards to provide the values of, among other things, assets and non-debt liabilities.

18. In this context, we consider that the ordinary meaning of the terms is the accounting meaning.[1]

Accounting meaning of assets and liabilities

19. For the purpose of preparing general purpose financial statements the Accounting Bodies[2] have defined assets in the *Statement of Accounting Concepts 4 Definition and recognition of the elements of financial statements (SAC 4)*, at paragraph 14 as follows:

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[1] A non-accounting or jurisprudential approach could result in some valuable assets and some commercial non-debt liabilities not being recognised. Furthermore, adopting an accounting meaning is likely to reduce compliance costs for taxpayers.

[2] SAC 4 was issued by the Australian Accounting Research Foundation (AARF) on behalf of The Institute of Chartered Accountants in Australia and the Australian Society of Certified Practising Accountants and by the Australian Accounting Standards Board

> '"Assets" are future economic benefits controlled by the entity as a result of past transactions or other past events'.

20. This meaning is explained further at paragraph 15 of SAC 4:

> 'The definition of assets identifies three essential characteristics. First, there must be future economic benefits. Second, the entity must have control over the future economic benefits such that it is able to enjoy the benefits and deny or regulate the access of others to the benefits. Third, the transaction or other event giving rise to the entity's control over the future economic benefits must have occurred.'

21. For accounting purposes 'liabilities' is defined in SAC 4 at paragraph 48 as:

> 'the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events'.

22. The Statement notes that equitable obligations and constructive obligations may be liabilities and comments at paragraph 57:

> '…[T]he concept of liabilities adopted in this Statement encompasses the financial obligations imposed by notions of equity or fairness, and by custom or usual business practices, as well as those resulting from legally enforceable contracts, from imposition by legally authorised bodies, from statutes or from torts.'

23. This explanation of the meaning of liabilities is different to the explanation in the explanatory memorandum accompanying the *New Business Tax System (Thin Capitalisation) Act 2001* which introduced Division 820 into the ITAA 1997 (the 'EM'). That explanation (at paragraph 2.53) stated that to be a liability the obligation had to be 'presently existing' in the sense that the event triggering the obligation had to have already occurred. The explanatory memorandum then provided an example of long service leave stating that it would not become a present obligation until the employee concerned actually took the leave.

24. Under the accounting definition, a liability is recognised if there is a present obligation to make a probable future sacrifice of economic benefits. Under this definition, something may be a liability even if the triggering event has not yet occurred provided that the entity has little if any discretion to avoid the obligation and it is probable that the obligation will arise. For example, if a business has an employee who has met the requisite qualifying period under the relevant award then, even though the employee has not taken the leave, at some time in the future the business will be required to pay that employee long service leave. In these circumstances a business

would be expected to show an accounting liability for the accrued leave in its balance sheet.

25. Having regard to the totality of factors which in combination form the thin capitalisation context, we consider that the accounting meaning of the word is the ordinary meaning in this context. Furthermore, notwithstanding the examples in the EM, all liabilities (excluding the specific items mentioned in the legislative definition) recognised under the accounting analysis are non-debt liabilities. If the accounting definition is used for assets we consider that it would not be appropriate to use another definition for liabilities.

Valuation of assets and liabilities.

26. The thin capitalisation legislation requires, in terms of section 820-680 that entities need to comply with accounting standards for the purpose of valuing (including revaluing) their assets and liabilities identified in accordance with paragraphs 4 and 5 of this Ruling. Additionally an entity's debt capital and equity capital is also to be valued in accordance with the accounting standards, as well as any revaluations for thin capitalisation purposes. The accounting standards for these purpose are the accounting standards as per the meaning in the *Corporations Act 2001* being the AASB series of accounting standards.

27. AASB 1001 *Accounting Policies* requires an entity to adopt an accounting policy that will result in financial information that is 'relevant' and 'reliable'. The accounting policies to be adopted in many circumstances are contained in the accounting standards that deal with particular topics. A non-exhaustive list of accounting standards relevant for this Ruling include AASB 1001 *Accounting Policies*, AASB 1008 *Leases*, AASB 1010 *Recoverable Amount of Non-Current Assets*, AASB 1011 *Accounting for Research and Development*, AASB 1013 *Accounting for Goodwill*, AASB 1015 *Acquisition of Assets*, AASB 1016 *Accounting for Investments in Associates*, AASB 1019 *Inventories*, AASB 1020 *Income Taxes*, AASB 1021 *Depreciation*, AASB 1022 *Accounting for the Extractive Industries*, AASB 1024 *Consolidated Accounts*, AASB 1041 *Revaluation of Non-Current Assets*.

28. In the absence of a particular accounting standard relevant to the item in question, paragraph 4 of AASB 1001 sets out the criteria for selection and application of an appropriate accounting policy. In this process to select an accounting policy, paragraph 4.1.2 of the standard lists, in the order of preference in which they should be applied, the pronouncements on accounting policies to be used. The order of preference contained in that standard is as follows:

a) the requirements and guidance in Accounting Standards or other authoritative pronouncements of the AASB and/or the PSASB (the Public Sector Accounting Standards Board) dealing with similar or relates issues;

b) the requirements and guidance in UIG (Urgent Issues Group) Consensus Views dealing with similar or related issues;

c) the definitions and recognition criteria for assets, liabilities, equity, revenues and expenses set out in Statement of Accounting Concepts SAC 4 'Definition and Recognition of the Elements of Financial Statements';

d) International Accounting Standards and Interpretations of the Standing Interpretations Committee of the International Accounting Standards Committee (only to the extent that these are consistent with (a), (b) and (c) of this paragraph); and

e) The pronouncements of other national accounting standard setting bodies and accepted industry practices (only to the extent that these are consistent with (a), (b) and (c) of this paragraph).

29. In valuing matters not dealt with by a specific standard, for thin capitalisation purposes we would expect compliance with AASB 1001 would include being able to demonstrate that the process and judgement used for selecting the accounting policy that was used to value the matters has followed the order of preference set out in paragraph 4.1.2 of that standard as detailed above.

30. In recognition of the fact that the financial statements may have been prepared with a slightly different focus, the thin capitalisation rules allow taxpayers to adopt alternative values for thin capitalisation purposes. However the legislation requires any revaluation of assets to be ascertained via an independent valuation and in accordance with accounting standards (see section 820-680).

Alternative View

31. An alternative view to that outlined above is that the definition of 'assets' and 'liabilities' takes a 'legal' or 'jurisprudential' meaning. Such an approach does not rely on the accounting standards for the basis of its analysis, but looks to the legal concepts underpinning these terms. Some support for this view may be gained in particular from the Explanatory Memorandum, (as an example refer to paragraph 24 above). However, having regard to the contextual factors discussed in paragraphs 16 to 19, we consider that the ordinary meaning of those terms in the thin capitalisation context is the accounting meaning.

Detailed contents list

32. Below is a detailed contents list for this draft Ruling:

Your comments

33. We invite you to comment on this draft Taxation Ruling. We are allowing 6 weeks for comment before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

Comments by Date: 31 July 2002

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Previous draft:
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Subject references:
- thin capitalisation
- assets
- liabilities
- valuations

Legislative references:
- ITAA 1997 Div 820
- ITAA 1997 820-95
- ITAA 1997 820-100
- ITAA 1997 820-105
- ITAA 1997 820-110
- ITAA 1997 820-195
- ITAA 1997 820-200
- ITAA 1997 820-205
- ITAA 1997 820-210
- ITAA 1997 820-215
- ITAA 1997 820-680
- ITAA 1997 995-1(1)
- Banking Act 1959
- Corporations Act 2001
- New Business Tax System (Thin Capitalisation) Act 2001

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