


# ***PS LA 2006/12 (Withdrawn) - Thin Capitalisation - Australian equivalents to International Financial Reporting Standards ('AIFRS') - Transitional Provision***

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 PS LA 2006/12 is withdrawn on 9 February 2012 due to amendments to the thin capitalisation provisions.

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## Practice Statement Law Administration

**PS LA 2006/12**

PS LA 2006/12 is withdrawn on 9 February 2012 due to amendments to the thin capitalisation provisions.

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**FOI status: may be released**

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*This Practice Statement is issued under the authority of the Commissioner and must be read in conjunction with Law Administration Practice Statement PS LA 1998/1. It must be followed by tax officers unless doing so creates unintended consequences or is considered incorrect. Where this occurs, officers must follow their business line's escalation process.*

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**SUBJECT:** Thin Capitalisation – Australian equivalents to International Financial Reporting Standards ('AIFRS') – Transitional Provision

**PURPOSE:** To provide guidance on certain practical issues arising where a taxpayer chooses under section 820-45 of the *Income Tax (Transitional Provisions) Act 1997* to use Australian accounting standards as they existed on 31 December 2004 to calculate their thin capitalisation position

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### BACKGROUND

1. The thin capitalisation legislation in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997) applies to Australian entities and their associate entities investing overseas through an overseas permanent establishment or Australian controlled foreign entity, and foreign entities investing directly into Australia or through foreign controlled Australian entities. The purpose of the Division is to limit the amount of debt used to fund those investments or Australian operations. The Division does this by limiting the debt deductions a taxpayer can claim against Australian assessable income when the entity's debt used to fund Australian operations exceeds a certain threshold.
2. Section 820-680 of the ITAA 1997 requires taxpayers to use the accounting standards in force under the *Corporations Act 2001* in order to determine what its assets and liabilities are and to calculate the value of its assets,<sup>1</sup> liabilities (including debt capital) and equity capital. Similarly, taxpayers are required to use the accounting standards to determine the profit of the entity when applying one of the arm's length tests (see paragraphs 820-105(3)(f), 820-215(3)(f), 820-315(3)(e) and 820-410(3)(e) of the ITAA 1997).

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<sup>1</sup> Subsection 820-680(2C) of the ITAA 1997 relating to the revaluation of one or more assets of a class constitutes an important exception to this rule.

3. For financial years beginning on or after 1 January 2005, the accounting standards in force under the *Corporations Act 2001* are the Australian equivalents to International Financial Reporting Standards (AIFRS).
4. There are a number of differences between Australian accounting standards as they existed on 31 December 2004 (AGAAP) and AIFRS. In a thin capitalisation context, the main differences relate to the treatment (specifically, recognition, classification and measurement) of balance sheet items such as intangibles, financial assets and liabilities, asset devaluations/impairments and goodwill. The changes made by AIFRS in these areas could result in a significant write down of net assets and/or profits for a number of taxpayers.
5. Taxpayers that calculate their thin capitalisation position using AIFRS may be unable to satisfy one or more of the relevant thin capitalisation tests resulting in the disallowance of debt deductions that would have been allowed had the reference to 'accounting standards' in Division 820 of the ITAA 1997 been a reference to AGAAP.
6. Section 820-45 (the transitional provision) of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997)) allows taxpayers to undertake calculations for thin capitalisation purposes using AGAAP for a transitional period of one or more of four income years commencing on or after 1 January 2005. In making the choice to use AGAAP in accordance with section 820-45, taxpayers will not be required to prepare a set of accounts based on AGAAP. A taxpayer is instead able to make adjustments to its AIFRS accounts in order to approximate what would have been its position under AGAAP<sup>2</sup> for thin capitalisation purposes.
7. There is no requirement that taxpayers that choose to apply the transitional provision and use AGAAP for thin capitalisation purposes in one year (or part-year period) must continue to use AGAAP for the remainder of the transitional period. Taxpayers may choose to use the transitional provision for any or all of the relevant income years.
8. This practice statement offers guidance to tax officers as to:
  - the types of adjustments taxpayers commonly will have to make when, in applying the transitional provision to calculate amounts applicable to the entity under Division 820 of the ITAA 1997, they approximate their AGAAP position by reference to their AIFRS accounts
  - the type of documentation taxpayers should keep to satisfy their record-keeping obligations when applying the transitional provision, and
  - the way the transitional provision interacts with the thin capitalisation rules on asset revaluations (see section 820-680 of the ITAA 1997).
9. The principles outlined in this practice statement apply equally to taxpayers that are Authorised Deposit-Taking Institutions (ADIs) and those that are not (that is, non-ADIs). In the context of ADIs, reference to AGAAP should be taken to be a reference to Australian accounting and prudential standards as they existed on 31 December 2004. Similarly, reference to AIFRS should be taken to be a reference to AIFRS and the current prudential standards.<sup>3</sup>

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<sup>2</sup> As modified by subsection 820-680(2C) of the ITAA 1997.

<sup>3</sup> The new prudential standards apply from 1 July 2006.

## STATEMENT

10. Where a taxpayer has chosen to use AGAAP under the transitional provision in an income year (or part-year period) for the purposes of calculating amounts applicable to the entity under Division 820 of the ITAA 1997, that choice will apply to all calculations made under the Division for that year. In particular, when calculating the average value of a particular matter (for example, assets of the taxpayer) under Subdivision 820-G of the ITAA 1997 for the income year or part-year period, the choice will apply in working out the value of the particular matter on each of the relevant measurement days.
11. There is only one exception to the general principle set out in paragraph 10 of this practice statement. Where the taxpayer has chosen to use AGAAP under the transitional provision and calculates an 'associate entity excess amount' and the associate has not chosen to use AGAAP when calculating amounts applicable to the associate under Division 820 of the ITAA 1997, the taxpayer is able to either use the AIFRS figures of the associate, or construct AGAAP figures from the AIFRS figures of the associate (subsection 820-45(3) of the IT(TP)A 1997).
12. Taxpayers that have chosen to apply the transitional provision for an income year (or part-year period) are not required to maintain a full set of accounts based on AGAAP for that period (refer also Note 1 to subsections 820-45(2) and (4) of the IT(TP)A 1997). A taxpayer may instead take its AIFRS accounts as a base and make adjustments to work back to a reasonable approximation of what would have been its position under AGAAP for the purposes of calculating amounts applicable to the entity under Division 820 of the ITAA 1997.
13. The Tax Office will take a common sense and practical approach that takes into account the taxpayer's compliance costs to evaluate whether or not a taxpayer choosing to use the transitional provision has used figures for the purposes of undertaking thin capitalisation calculations that are reasonable approximations for figures that would have been produced using AGAAP. In this regard, the Tax Office recognises that during the transitional period taxpayers will no longer be operating accounting systems that would allow them to generate accurate AGAAP figures.
14. A taxpayer that chooses to approximate its AGAAP position (rather than keep a full set of AGAAP accounts) must keep documents that record and explain how the taxpayer has adjusted back to what would have been its position under AGAAP from its AIFRS accounts. The adequacy and type of documentation that a taxpayer must keep will depend on the nature of the taxpayer's business and on the size and types of adjustments the taxpayer needs to make to its AIFRS accounts in order to work back to a reasonable approximation of what would have been its position for thin capitalisation purposes under AGAAP.
15. The onus rests upon the taxpayer to prepare and retain documentation that explains how the adjustments made in working back to an AGAAP position for the purposes of the transitional provision lead to a reasonable approximation of the amounts applicable to the entity under Division 820 of the ITAA 1997 that would have been calculated had the taxpayer's accounts been prepared in accordance with AGAAP. In many instances, it is expected that the documents taxpayers will maintain as a matter of ordinary commercial practice will suffice in this regard.

## EXPLANATION

### When will adjustments be required?

16. If a taxpayer chooses to use AGAAP for the purposes of calculating amounts applicable to the entity under Division 820 of the ITAA 1997, but does not maintain a full set of AGAAP accounts, the taxpayer will need to make adjustments to its AIFRS figures for the relevant income years to work back to a reasonable approximation of what would have been its position under AGAAP.<sup>4</sup> In undertaking this exercise, a two step process may be followed.

### *The first step*

17. The taxpayer's first step will be to identify those areas where the change in accounting standards from AGAAP to AIFRS may have impacted on its financial accounts (whether positively or negatively). This requires the taxpayer to identify which AIFRS standards used by the taxpayer in preparing its AIFRS accounts effected a change to the position pertaining under AGAAP.
18. The following non-exhaustive list contains examples of AIFRS standards that both effected a change to the position pertaining under AGAAP and are likely, but for the existence of the transitional provision, to affect the net asset and/or profitability, and hence thin capitalisation, position of some taxpayers.
- **AASB 2 Share-based Payment** which generally requires share-based payments to be expensed
  - **AASB 3 Business Combinations** which specifies that all business combinations should be accounted for by applying the purchase method (that is, the acquirer recognises the acquiree's identifiable assets, liabilities and contingent liabilities at fair value, and also recognises goodwill). The standard makes it clear that joint ventures and reorganisations involving entities under common control are not captured by the new business combination rules. Further, goodwill recognised in a business combination cannot be amortised and is only subject to impairment
  - **AASB 112 Income Taxes** which requires a balance sheet approach to calculate deferred tax balances
  - **AASB 116 Property, Plant and Equipment** which requires when using the Revaluation model that asset revaluation decrements be accounted for on an asset specific basis rather than applying a class of asset approach, so that decrement amounts are expensed to the profit and loss statement in certain situations
  - **AASB 118 Revenue** which states that certain income that would have been recognised under AASB 1004 may be deferred and be recognised in a later period
  - **AASB 119 Employee Benefits** which requires sponsors of defined benefit superannuation plans to recognise an asset or liability in relation to the fund based on an actuarial assessment

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<sup>4</sup> As modified, where relevant, by subsection 820-680(2C) of the ITAA 1997.

- **AASB 123 Borrowing Costs** which provides a choice between the capitalisation or expensing of borrowing costs directly attributable to qualifying assets
- **AASB 128 Investments in Associates** which requires that, for the purposes of recognising an investor's share of losses of an associate, the carrying amount of the investment includes any long-term interest that, in substance, forms part of the investor's net investment in the associate (for example, preference shares and long-term receivables or loans)
- **AASB 132 Financial Instruments: Disclosures and Presentation** which redefines the concept of liability and may require reclassification of certain financial instruments from equity to debt
- **AASB 136 Impairment of Assets** which provides for a more rigorous and prescriptive impairment test for assets
- **AASB 137 Provisions, Contingent Liabilities and Contingent Assets** which requires companies to reconsider their policies in relation to provisions, contingent liabilities and contingent assets such as restoration and rehabilitation liabilities
- **AASB 138 Intangibles** which provides, for example, that:
  - intangible assets must be recognised at cost and can only be revalued if there is an active market for the asset, and
  - certain intangible assets that are internally generated (for example, brand names, mastheads and customer lists) cannot be recognised as assets
- **AASB 139 Financial Instruments: Recognition and Measurement** which requires that some financial assets and liabilities, including derivatives, need to be recorded in the balance sheet, with most financial assets being recognised at fair value.

### ***The second step***

19. The taxpayer's second step will be to make those positive and negative adjustments to its AIFRS accounts that are necessary to work back to a reasonable approximation of what would have been the taxpayer's thin capitalisation position if the reference in Division 820 of the ITAA 1997 to 'accounting standards' were a reference to AGAAP. Adjustments may need to be made to the asset, liability or equity parts of the taxpayer's balance sheet and/or to the profit and loss.
20. When identifying what adjustments to make, the fact that the taxpayer has identified an area as one where there are likely to be differences between its AGAAP and AIFRS positions does not mean an adjustment to the AIFRS accounts will necessarily be warranted in relation to that area. That will depend on the anticipated:
  - size and type of the adjustment in the context of the specific circumstances of the taxpayer's business, and
  - effect that the adjustment would have on one or more of the Division 820 amounts applicable to the taxpayer.

21. Subject to paragraph 22 of this practice statement, if the difference between the AIFRS and AGAAP amounts for a particular item is expected to be small relative to the taxpayer's overall business, an adjustment will not be required (although the taxpayer could choose to make an adjustment if it so wished).
22. If, however, the taxpayer has reasonable grounds to suppose that the difference between the AIFRS and AGAAP amounts for a particular item or items will be sufficient, separately or in aggregate, to cause the taxpayer's debt to exceed the relevant thin capitalisation threshold used to determine its thin capitalisation position for that income year, adjustments will be required. In this case, the taxpayer cannot choose *not* to make an adjustment notwithstanding that the difference may be small relative to the taxpayer's overall business.

### **Types of adjustments**

23. The types of adjustments that a taxpayer may have to make to arrive at its AGAAP position for the purpose of calculating amounts applicable to the taxpayer under Division 820 of the ITAA 1997 will fall into three main categories:
- adjustments of a type that the taxpayer made upon transition to AIFRS when it prepared its 'opening Australian-equivalents-to-IFRS balance sheet' and its 'first Australian-equivalents-to-IFRS financial report' (or which would have been made if the taxpayer was required to prepare its accounts in accordance with AIFRS) and which remain relevant in each subsequent year that the taxpayer chooses to apply the transitional provision ('base adjustments')
  - additional adjustments that become necessary as a result of changes to the taxpayer's business that occur after the taxpayer's transition to AIFRS, for example, as a result of the acquisition or disposal of assets, and
  - adjustments that are necessary because the taxpayer commences to carry on a new business after the date of commencement of AIFRS and consequently has not produced financial accounts using AGAAP.

### ***Base adjustments***

24. Where post transition to AIFRS the business of a taxpayer does not change in such a manner as to cause the taxpayer to reasonably suspect that other adjustments may be necessary to reach a reasonable approximation of what would have been its thin capitalisation position under AGAAP, it will suffice for the taxpayer in working back to its AGAAP position in each of the transitional years to simply make relevant base adjustments.

25. Where a taxpayer was required to prepare its accounts in accordance with AGAAP prior to adopting AIFRS, the entity will, pursuant to *AASB 1 First-time adoption of Australian Equivalents to International Financial Reporting Standards*, prepare an 'opening Australian-equivalents-to-IFRS balance sheet' as at the date of transition and, at the end of its first financial period after its transition to AIFRS, a 'first Australian-equivalents-to-IFRS financial report'. These documents will disclose and reconcile the base adjustments that were made to the taxpayer's balance sheet and income and expense items upon the taxpayer's transition from AGAAP to AIFRS.
26. The Commissioner will accept the opening balance sheet and first financial report, together with the associated working papers, as sufficient documentary evidence of the base adjustments made in that year. This material will suffice to identify the types of base adjustments required in each subsequent year of income in which the taxpayer chooses to adopt the transitional provisions.
27. The Commissioner will also accept the opening balance sheet and first financial report prepared by taxpayers who, while not statutorily required to use AGAAP in preparing accounts, nonetheless prepared accounts in accordance with AGAAP and have therefore sought to disclose and reconcile the base adjustments to their accounts arising from the change from AGAAP to AIFRS.

***Adjustments that become necessary as a result of changes to the taxpayer's business***

28. If the taxpayer's business changes post transition, it may not suffice for the taxpayer simply to make base adjustments to arrive at a reasonable approximation of what the taxpayer's thin capitalisation position under AGAAP would have been. The taxpayer will also need to consider what, if any, other adjustments are necessary. Where the taxpayer determines other adjustments are necessary, it is generally expected that the documents a taxpayer maintains as a matter of ordinary commercial practice will suffice to record and explain how and why the further adjustments are appropriate.

***Adjustments that are necessary because the taxpayer has commenced a new business***

29. Where a taxpayer commences to carry on a new business after the date of commencement of AIFRS, and consequently has not previously produced financial accounts using AGAAP, the taxpayer will need to bring into existence documentation which demonstrates how and why any adjustments to its AIFRS accounts lead to a reasonable approximation of what would have been the taxpayer's thin capitalisation position had the reference to 'accounting standards' in Division 820 of the ITAA 1997 been a reference to AGAAP.
30. For example, the documentation should explain why the relevant accounting pertaining under AIFRS produces a different outcome to that which would have been obtained by applying AGAAP.



## Revaluation of assets

### **Generally**

31. Taxpayers are required to comply with accounting standards when valuing and revaluing assets for thin capitalisation purposes (subsection 820-680(1) of the ITAA 1997).
32. While an entity may use a value of an asset other than the value reflected in its books of account, the general rule is that revaluations must be made by a person who is an expert in valuing assets (subsection 820-680(2) of the ITAA 1997). Further, the taxpayer must keep records regarding the revaluation covering such matters as the methodology used in making the revaluation and the qualifications of the expert who made the valuation (section 820-985 of the ITAA 1997).
33. Where, however, an entity undertakes a revaluation of its assets and that revaluation is reflected in its *statutory* accounts, then the revaluation can be used for thin capitalisation purposes irrespective of whether the revaluation has been made by an expert (subsection 820-680(2A) of the ITAA 1997).

### **Under the transitional provision**

34. Post transition to AIFRS a taxpayer may, in working back to a reasonable approximation of what its position under AGAAP would have been for thin capitalisation purposes, choose to undertake a revaluation of one or more of its assets. The assets may have been acquired before or after the transition to AIFRS and may or may not be recognised under AIFRS.
35. Providing the revaluation would have been permitted under AGAAP, the taxpayer may adjust its AIFRS accounts to reflect the asset revaluation.
36. If the taxpayer is required by an Australian law to prepare financial statements, the Commissioner will accept that subsection 820-680(2A) of the ITAA 1997 is satisfied and an expert's valuation will not be required. This is on the basis that had the entity's financial statements been prepared in accordance with AGAAP, the financial statements could have reflected the valuation.<sup>5</sup> If the taxpayer is not required by law to prepare financial statements, an expert's valuation will be required to support the revaluation.
37. Where an asset is or has been revalued in circumstances where the revaluation would have been permitted but not required by AGAAP then, for each of the years in which the taxpayer elects to use the transitional provision, the taxpayer is required to continue to revalue the asset at the frequency that would have been required by the relevant AGAAP standard (subsections 820-680(2D) and (2E) of the ITAA 1997).

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<sup>5</sup> Note, however, the valuation must comply with the relevant AGAAP standards. If the Commissioner considers that an asset has been overvalued he has the power to substitute a value that he considers is appropriate having regard to AGAAP (section 820-690 of the ITAA 1997).

38. Also, when adjusting AIFRS accounts to reflect revaluations that would have been required or permitted under AGAAP, the general rule is that all assets in an asset class must be revalued. While the thin capitalisation provisions allow for the revaluation of individual assets, this may only occur where no asset in the asset class has fallen in value (subsection 820-680(2C) of the ITAA 1997). Where assets in the class have fallen in value then the AIFRS accounts must be adjusted to reflect the revaluation of the entire class having regard to the relevant AGAAP standards if the revaluation amount of one asset of the class is to be used for thin capitalisation purposes.

### **Documentation**

39. Section 262A of the *Income Tax Assessment Act 1936* (ITAA 1936) sets out the record keeping obligations of taxpayers. In accordance with section 262A of the ITAA 1936, where a taxpayer has chosen to use the transitional measure provided by section 820-45 of the IT(TP)A 1997, the taxpayer should maintain documentation which explains how they calculated their thin capitalisation position. This remains so even where a taxpayer has chosen to apply AGAAP for the purposes of calculating its thin capitalisation position and is either commencing to carry on a business for the first time after 31 December 2004 or is not required to prepare a set of financial accounts.
40. As a general statement, the type of documentation that will need to be maintained by a taxpayer in order to satisfy the taxpayer's record keeping obligations will depend on the nature of the taxpayer's business and on the size and type of adjustment the taxpayer needs to make to its AIFRS accounts in order to work back to a reasonable approximation of what would have been their thin capitalisation position under AGAAP.
41. In providing guidance on the types of documentation the Commissioner would expect to see in place, the Commissioner is not seeking to prescribe in detail the documents that need to be maintained. The onus rests upon a taxpayer to provide evidence that the adjustments made in working back to a set of AGAAP figures for the purposes of calculating their thin capitalisation position are appropriate and lead to a reasonable approximation of the figures that would have been produced using AGAAP. If the taxpayer cannot produce documentation that a party in the same position as the taxpayer exercising reasonable care would have been expected to keep, it is likely that the taxpayer's thin capitalisation calculations will be subject to more detailed scrutiny by the Tax Office than would otherwise be the case.

## Examples

### Example 1

42. In its first income year after its transition to AIFRS, Blueberry Ltd ('Blueberry') had an annual turnover of \$1 million, assets of \$500,000 and liabilities of \$300,000. During the year, Blueberry commenced to hold a business name (internally generated) valued at \$100,000. Under AIFRS the business name does not satisfy the tests for recognition as an asset. If Blueberry chose to use the transitional provision to calculate its thin capitalisation position during the transitional period, it would be appropriate for Blueberry to make an adjustment to its AIFRS accounts adding back the value of the asset in order for Blueberry to reach a reasonable approximation of what the relevant Division 820 amounts applicable to the company would have been had its thin capitalisation position been determined by reference to AGAAP. This follows from the observation that the difference between the values ascribed to the asset under AGAAP and AIFRS cannot be said to be small relative to Blueberry's business.
43. Alternatively, if in the year Blueberry had a turnover of \$1 billion, assets of \$50 million and liabilities of \$30 million, it would not be necessary for Blueberry to make an adjustment to add back the value of the asset in working out a reasonable approximation of what would have been its thin capitalisation position under AGAAP. In this alternative scenario it may be expected that the impact of any adjustment made to reflect changes in the relevant accounting treatment would be small (assuming that it is reasonable to suppose that the adjustment, when considered together with other related adjustments, would not cause Blueberry's debt to asset ratio to exceed one or more all of the thin capitalisation gearing tests). It would remain open to Blueberry, however, to make the relevant adjustment if it so chose.

### Example 2

44. Peach Ltd ('Peach') is a shipping company. It provides services to mining and manufacturing companies domestically and internationally. It also operates a television and radio network.
45. Peach holds two intangible assets being television licences and an internally generated trademark valued at \$150 million and \$500 million respectively under AGAAP immediately prior to the company's transition to AIFRS. The television licences were purchased at a cost of \$48 million and revalued at their fair value under AGAAP.
46. Peach has elected to use the transitional provision and uses the opening and closing balances method in calculating the average value of its assets and liabilities (refer section 820-635 of the ITAA 1997).
47. Internally generated brands are specifically excluded from recognition under paragraph 63 of *AASB 138 Intangible Assets*. In accordance with paragraph 9 of AASB 1, assets not recognised under AIFRS are not permitted to be recognised in the opening balance sheet of the entity. Further, under AIFRS an intangible asset may only be carried at a revalued amount after initial recognition where an active market exists for that intangible asset.
48. As a consequence of this, upon transition to AIFRS, Peach derecognised the trademark and restated the television licences on its books at cost.

49. During the first year after its transition to AIFRS, Peach sold its television and radio network, thereby disposing of its television licences.
50. In working out what its position for thin capitalisation purposes would have been under AGAAP for the year, Peach may use as its opening balance asset figure \$650 million (equalling its opening balance under AIFRS of \$48 million plus a base adjustment of \$602 million adding back the value of the trademark and the revaluation of the licences) and \$500 million as its closing balance asset figure (equalling its opening balance under AIFRS of \$48 million plus a base adjustment of \$602 million less a subsequent adjustment of \$150 million (reflecting the sale of the licences)).

### **Example 3**

51. Pear Ltd ('Pear') operates a number of businesses in Australia and overseas. Pear publishes a newspaper and produces beverages.
52. Pear holds two intangible assets being an internally generated masthead and bottling agreements valued at \$200 million and \$80 million respectively under AGAAP immediately prior to Pear's transition to AIFRS. The bottling agreements were purchased at a cost of \$60 million and revalued at their fair value under AGAAP.
53. During the first year after its transition to AIFRS, Pear spent \$10 million developing its masthead which was expensed under AIFRS but qualified for asset recognition under AGAAP.
54. Pear has elected to use the transitional provision and uses the opening and closing balances method in calculating the average value of its assets and liabilities (refer section 820-635 of the ITAA 1997).
55. Internally generated mastheads are specifically excluded from recognition under paragraph 63 of AASB 138. In accordance with paragraph 9 of AASB 1, assets not recognised under AIFRS are not permitted to be recognised in the opening balance sheet of the entity. Further, under AIFRS an intangible asset may only be carried at a revalued amount after initial recognition where an active market exists for that intangible asset.
56. As a consequence of this, upon transition to AIFRS Pear derecognised the masthead and restated the bottling agreements on its books at cost.
57. In working out what its position for thin capitalisation purposes would have been under AGAAP for the year, Pear may use as its opening balance asset figure \$280 million (equalling its opening balance under AIFRS of \$60 million plus a base adjustment of \$220 million adding back the value of the masthead and the revaluation of the bottling agreements), and \$290 million as its closing balance asset figure (equalling its opening balance under AIFRS of \$60 million plus a base adjustment of \$220 million plus a subsequent adjustment of \$10 million (reflecting the \$10 million spent in developing the masthead which would have qualified for asset recognition under AGAAP)).

#### **Example 4**

58. PJ Ltd ('PJ') recorded a profit of \$5 million for the second year after its transition to AIFRS for its commercial activities in connection with Australia.
59. During the year PJ held two items of plant and equipment: Asset 1 and Asset 2. During the year, PJ revalued Asset 1 upwards by \$2 million and revalued Asset 2 downwards by \$1 million. Asset 2 had not previously been revalued upwards.
60. Paragraph 40 of *AASB 116 Property, Plant and Equipment* requires that a revaluation decrement be charged directly against any related revaluation reserve only to the extent that the decrease does not exceed the amount held in the revaluation reserve in respect of that same asset. The remaining revaluation decrement is charged to the profit and loss account as an expense. On this basis, the revaluation by PJ of Asset 2 downwards resulted in recognition of an expense of \$1 million by PJ.
61. By contrast, the relevant AGAAP standard allowed revaluation increments / decrements to be offset against one another within a class of non-current assets (refer paragraph 5.4 of *AASB 1041 Revaluation of Non-Current Assets*). As such, entities were allowed to offset revaluation decrements for one asset against a balance in a revaluation reserve relating to other assets of the same class.
62. While PJ did not use the transitional provision for its first year after transition to AIFRS, PJ has elected to use the transitional provision for the current year. In calculating its arm's length debt amount under section 820-105 of the ITAA 1997, PJ must take into account the various factors listed in subsection 820-105(3). One of these factors is its profit for the year from its commercial activities in connection with Australia (refer paragraph 820-105(3)(f)).
63. Had PJ prepared its accounts under AGAAP for the year, PJ would have been able to offset the revaluation decrement for asset 2 against the revaluation reserve for asset 1 resulting in no expense being charged against the profit of the entity. As such, in working out what its arm's length debt amount would have been under AGAAP for the year, PJ may use as its profit figure \$6 million (equalling its AIFRS profit figure of \$5 million plus a \$1 million adjustment adding back the amount PJ recognised as an expense under AIFRS).

#### **Example 5**

64. Lemon Ltd ('Lemon') is a computer software distributor. As at the date of transition to AIFRS Lemon held various assets including internally generated computer software which was valued at \$30 million under AGAAP.
65. Lemon is required under the *Corporations Act 2001* to prepare financial statements. In the preceding income years, Lemon measured the software on a fair value basis as permitted by AASB 1041, revaluing the software with sufficient regularity to ensure that the carrying value of the software did not differ materially from its fair value. In particular, the software was revalued upwards by \$4 million (from \$18 million) in 2004 and by a further \$8 million (from \$22 million) in 2005. Each revaluation was reflected in Lemon's statutory financial statements and thus satisfied the requirements of subsection 820-680(2A) of the ITAA 1997 in each of those income years. As such, Lemon was not required under Division 820 to have had the computer software revalued by an expert in valuing software.

66. Upon transition to AIFRS, Lemon restated the computer software on its books at cost (namely \$18 million).
67. Lemon has elected to use the transitional provision. Lemon revalued the software in 2006. The result of the revaluation was \$32 million. Lemon may add back \$14 million to the asset figures derived from its AIFRS accounts for thin capitalisation purposes in order to reach a reasonable approximation of what the relevant Division 820 amounts applicable to Lemon would have been had its thin capitalisation position been determined by reference to AGAAP. It is not necessary for the 2006 revaluation of the software to have been made by a person who was an expert in valuing software.

### **Example 6**

68. Mango Ltd ('Mango') has purchased an office building on 30 June 2005 for \$250 million. The office building is currently leased for another 4 years. In its financial accounts for year ended 30 June 2005 it recorded a carrying amount of \$250 million for the asset in its balance sheet prepared under AGAAP for the year immediately prior to the company's transition to AIFRS.
69. For the financial year ended 30 June 2006, Mango, in accordance with the relevant AIFRS standard (refer paragraph 30 of *AASB 140 Investment Property*), revalues the building to its fair value of \$260 million.
70. Paragraph 20 of *AASB 112 Income Taxes* requires entities to recognise a deferred tax liability (DTL) in respect of asset revaluations. Accordingly Mango recognises a DTL of \$3 million in its books of account.<sup>6</sup> By contrast, Mango would not have been required to recognise a DTL in its balance sheet if it had accounted under AGAAP for the 2006 year. This is because Mango historically applied *AASB 1020 Accounting for Income Tax (Tax-effect Accounting)* (1989 version) for the purposes of accounting for tax effects. AASB 1020 adopted an income statement approach to accounting for income taxes.
71. Mango has elected to use the transitional provision.
72. For 2006, Mango may make an adjustment to its AIFRS accounts in effect derecognising the \$3 million DTL in order to reach a reasonable approximation of what the relevant Division 820 amounts applicable to Mango would have been had its 2006 thin capitalisation position been determined by reference to AGAAP.
73. For 2006, Mango does not have to make an adjustment to AIFRS accounts to derecognise the revaluation of the office building. This is because under the relevant AGAAP standard (*AASB 1041 Revaluation of Non-Current Assets*), Mango would have been entitled to revalue the building.

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<sup>6</sup> In this example, the DTL of \$3 million has been calculated as the temporary taxable difference of \$10 million multiplied by the company tax rate (30%). The temporary taxable difference has been calculated by deducting the tax base of the asset from the revalued carrying amount of the asset, being \$10 million (\$260 million less \$250 million). For the purposes of this example any tax deductions that Mango may have been entitled to under the *Income Tax Assessment Act 1997* have not been taken into account when working out the value of the tax base of the office building.

Subject references	accounting standards associate entity excess amount debt capital debt deductions measurement days prudential standards thin capitalisation
Legislative references	ITAA 1936 262A IT(TP)A 1997 820-45 IT(TP)A 1997 820-45(2) IT(TP)A 1997 820-45(3) IT(TP)A 1997 820-45(4) ITAA 1997 820 ITAA 1997 820-G ITAA 1997 820-105 ITAA 1997 820-105(3) ITAA 1997 820-105(3)(f) ITAA 1997 820-215(3)(f) ITAA 1997 820-315(3)(e) ITAA 1997 820-410(3)(e) ITAA 1997 820-635 ITAA 1997 820-680 ITAA 1997 820-680(1) ITAA 1997 820-680(2) ITAA 1997 820-680(2A) ITAA 1997 820-680(2C) ITAA 1997 820-680(2D) ITAA 1997 820-680(2E) ITAA 1997 820-690 ITAA 1997 820-985
other references	AASB 1; AASB 2; AASB 3; AASB 112; AASB 116; AASB 118; AASB 119; AASB 123; AASB 128; AASB 132; AASB 136; AASB 137; AASB 138; AASB 139; AASB 140; AASB 1004,AASB 1020; AASB 1041
File references	05/10227
Date issued	20 September 2006
Date of effect	1 January 2005
Amendment history	<b>31 July 2007</b> <b>Paragraph 6: increase transitional period from three to four years following announcement in 2007/08 Budget.</b>
Other Business Lines consulted	<b>LB&amp;I, SB, OCTC, TCN</b>