TA 2016/1 - Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes

This cover sheet is provided for information only. It does not form part of *TA 2016/1 - Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes*

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

Under the new thin capitalisation rules:

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

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

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

Australian Government
Australian Taxation Office

Taxpayer Alert

TA 2016/1

Inappropriate recognition of internally generated intangible assets and revaluation of intangible assets for thin capitalisation purposes

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

Under the new thin capitalisation rules:

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

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

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

This Alert provides a summary of our concerns about a significant, emerging or recurring higher risk tax issue that we currently have under risk assessment.

While an alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to PS LA 2008/15 for more about alerts. See Alerts issued to date.

Description

The ATO is reviewing arrangements where internally generated intangible items have been inappropriately recognised as assets, or have been over valued or inappropriately re-valued, with the consequence of increasing an entity's maximum allowable debt limit for thin capitalisation purposes. We have concerns that in some cases these items are not capable of meeting the definition of an intangible asset for recognition under the applicable accounting standard (as modified by the relevant statutory provisions discussed below).

We are currently reviewing arrangements which display the following features:

- As part of calculating asset values for thin capitalisation purposes, an entity –
  - identifies an internally generated intangible item, the purported economic value of which is not disclosed in the entity's financial accounts; or
  - identifies an intangible asset disclosed in the financial accounts, the purported current economic value of which is not reflected in the entity's financial accounts.
- The entity makes a choice pursuant to subsection 820-683(2) of the *Income Tax Assessment Act 1997* (ITAA 1997) to recognise the internally generated intangible item as an asset for the purposes of its thin capitalisation calculation, in circumstances where such an asset would not otherwise qualify for recognition under the applicable accounting standards, and then determines the value of that item for those purposes.
- Alternatively, the entity makes a choice pursuant to subsection 820-684(2) of the ITAA 1997 to revalue an intangible asset for the purposes of its thin capitalisation calculation, in circumstances where such an asset would not otherwise qualify for revaluation under the applicable accounting standards.
- The effect of either choice is to significantly increase the average value of assets for the purpose of the thin capitalisation calculation, allowing an increase in the calculated maximum allowable debt amount.
- The choices to recognise an internally generated asset or revalue an intangible asset appear to be outside the scope of the special rules that modify the application of accounting standards for thin capitalisation purposes.
- The value of the internally generated intangible item or revalued intangible asset is often materially large compared to the value of other assets disclosed in the entity's financial statements.
- The additional maximum allowable debt capacity created by the recognition or revaluation allows the entity to claim additional debt deductions that would otherwise have been denied by the thin capitalisation limits or increases the debt loading capacity of the entity for future income years.

What are our concerns?

We are concerned that in some circumstances entities are making choices to recognise internally generated items, where the item chosen falls outside the scope of the intangible asset recognition criteria in Australian Accounting Standards Board's standard AASB 138 *Intangible Assets* (AASB 138). As a consequence these internally generated intangible items do not satisfy the special asset value rules that modify the application of accounting standards for thin capitalisation purposes (sections 820-683 and 820-684 of the ITAA 1997).

Whilst a taxpayer may expend resources to internally generate intangible items, not all of these items will meet the definition of an intangible asset (refer to paragraphs 9 and 10 of AASB 138). For example, such expenditure might not be recognised as an asset because it does not result in the creation of an identifiable resource which is separable from the internally generated goodwill of a business.

We are concerned about the following arrangements:

- Inappropriate recognition of internally generated intangible items pursuant to section 820-683 of the ITAA 1997. In particular, certain arrangements do not take

into account that section 820-683 only modifies the ‘cost’ requirement for recognition under the accounting standard AASB 138. All other recognition criteria of that standard (identifiability, control over a resource and existence of future benefits) are still required to be satisfied for the item to qualify as an internally generated intangible asset (refer to paragraph 10 of AASB 138). Accordingly, we are concerned with choices made to recognise internally generated intangible items where –

- the item cannot be separated from the entity (either individually or together with a related contract) or does not arise from contractual or other legal rights;
- the entity does not have the requisite control over the internally generated item; or
- all the potential future economic benefits of the intangible item do not flow to the taxpayer.

Examples of inappropriately recognised items include (from our compliance activities) –

- market related items such as ‘customer relationships’ or ‘customer loyalty’;
- human resource items, including ‘skilled staff’, ‘management’ or ‘key employees/training’;
- organisational resource items, including ‘internal policies’, ‘internal meeting protocols’, ‘procedures’ and ‘manuals’; and
- assets not owned and controlled by the taxpayer.

- From an asset revaluation perspective, some of our currently identified concerns are in respect of the following:
  - Applying unsupportable or questionable management assumptions. For example –
    - Software valuations which assume a useful life of 25 years or more
    - Growth rates in excess of historic and probable market indicators.
  - Generic material such as internal policies, internal meeting protocols and procedures being revalued.
  - Double counting of asset value across multiple intangibles (e.g. recognition and revaluation of separate ‘business processes’ items connected to intellectual property), including failure to correspondingly impair other intangible assets where the ‘revalued’ intangible asset relies on the same underlying economic returns.
  - Revaluing the intangible asset based on economic returns which do not accrue to the taxpayer.
- Entities not impairing assets where the fair value or the cash generating unit has declined (as required by AASB 136 *Impairment of Assets*).

What are we doing?

We are currently reviewing these arrangements and have commenced compliance activities in relation to a number of cases. We have received external expert advice on the application of the relevant accounting standards.

Our compliance activities have resulted in adjustments where the intangible item has not qualified as an internally generated asset as defined under AASB 138 (as modified by section 820-683 of the ITAA 1997), or where the revaluation of an intangible asset has been excessive. Similarly we have made adjustments where subsequent impairment of revalued assets should have occurred.

The Commissioner is also considering the extent of his power under section 820-690 of the ITAA 1997 to substitute more appropriate asset values where the Commissioner considers that an entity has overvalued its assets, and the circumstance in which it would, or might be appropriate to exercise this power.

Compliance activity will continue and we will provide further guidance on the technical accounting and legal positions of these arrangements. We will also canvass our concerns as well as practices we find acceptable in further detail in guidance products and professional forums.

What should you do?

If you have made a choice to recognise or revalue intangible assets for your thin capitalisation calculation, or are contemplating doing so, we recommend that you seek independent advice, review your arrangement or discuss your situation with us by emailing us at PGIAdvice@ato.gov.au

References

Subject References:

- Thin capitalisation
- Asset values
- Revaluation
- Intangible assets
- Debt deduction

Date issued:	**26 April 2016**
Authorised by:	**Mark Konza** Deputy Commissioner
Contact officer: Business line: Phone:	**Paul Korganow** Public Groups and International (03) 8601 9505