

Chapter 3

Schedule 2—Thin capitalisation—Excluded equity interests

3.1 The ATO refers to this measure as a 'technical correction'.¹ The Explanatory Memorandum states that the amendment 'corrects an unintended consequence'.² To prevent manipulation of the thin capitalisation rules — through temporary, artificial inflation of equity and asset levels — certain short-term equity interests are excluded from thin capitalisation calculations for income years beginning on or after 1 July 2002.

3.2 The bill amends the definition of 'excluded equity interest' in the *Income Tax Assessment Act 1997* (ITAA 1997) to ensure that equity interests that remain on issue for a total period of 180 days or more do not become excluded equity interests, even if those interests have been on issue for less than 180 days at the valuation day.³

Background⁴

3.3 The thin capitalisation rules in Division 820 of the ITAA 1997 are designed to ensure that both Australian and foreign-owned multinational entities do not allocate an excessive amount of debt to their Australian operations. The rules operate to disallow a proportion of otherwise deductible finance expenses (eg interest payments) where the debt used to fund the Australian operations exceeds certain thresholds.

3.4 The thin capitalisation rules contain a number of integrity measures to prevent entities manipulating them. An 'excluded equity interest' is an example of an integrity measure. It is defined in subsection 820-946(2A) of the ITAA 1997. This provision is intended to prevent an entity (other than an authorised deposit-taking institution) from issuing a short-term equity interest just prior to the day on which its assets are valued for thin capitalisation purposes (the valuation day) — thereby increasing its assets and potentially allowing the entity to hold more debt under the safe harbour test — and then cancelling the interest shortly thereafter.

3.5 Manipulation of the value of an entity's assets by the use of short-term equity interests is possible where the interest holder is not subject to the thin capitalisation

1 Australian Taxation Office (ATO) website, (accessed 22 August 2007):
<http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00105190.htm>

2 EM, p. 118.

3 Australian Taxation Office (ATO) website, (accessed 22 August 2007):
<http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/00105190.htm>

4 EM, pp 117–118.

rules (eg, because it is an exempt entity), or where the issuer and holder of the interest are both subject to the rules but have different valuation days.

3.6 An equity interest that is an excluded equity interest is deducted from the total assets of the entity that issues the interest, which in turn reduces its maximum allowable debt. Thus, the issuer is prevented from gaining an advantage where such equity interests are issued prior to a valuation day and cancelled shortly thereafter.

3.7 The current definition of excluded equity interest excludes from thin capitalisation calculations equity interests that have been on issue for less than 180 days at the valuation day, regardless of how long those interests ultimately remain on issue. This is an unintended consequence of the definition, as it may capture equity interests that remain on issue for a total period of 180 days or more and are genuinely intended to be long-term.

3.8 Therefore, Schedule 2 of the bill amends the definition of 'excluded equity interest' in subsection 820-946(2A) of the ITAA 1997, the effect of which is to exclude from the definition certain long-term equity interests.

3.9 There were no submissions received in relation to this Schedule.