Chapter 3

Schedule 2—modification of the thin capitalisation regime

Background

3.1 On 24 January 2005, the former Treasurer announced a three-year transitional period in respect of the application of Australian equivalents to International Financial Reporting Standards (AIFRS) under the thin capitalisation rules in Division 820 of the *Income Tax Assessment Act 1997*.

3.2 In the period following this announcement, entities would elect, on an annual basis, to use either AIFRS or the previous accounting standards, the Australian Generally Accepted Accounting Principles, to make thin capitalisation calculations.[1]

3.3 When making this announcement, the former Treasurer also indicated that the Government would examine whether the existing thin capitalisation rules, following the adoption of AIFRS, were appropriate.

3.4 On 13 May 2008, the Treasurer and the Assistant Treasurer and Minister for Competition Policy and Consumer Affairs jointly announced that the government will amend the thin capitalisation regime to accommodate certain impacts arising from the adoption of the AIFRS accounting standards. For example, certain assets and liabilities will not be permitted to be recognised by particular entities for thin capitalisation purposes.

3.5 In adopting globally accepted standards, Australia more closely aligns itself with international accounting practice. In addition, through adopting such standards, Australia can facilitate comparisons of cross-jurisdictional financial information and reduce the complexity for investors when making investment decisions.

Thin capitalisation

3.6 A non-financial company is said to be thinly capitalised when its liabilities are made up of a much greater proportion of debt than equity.

3.7 This is perceived to create problems for two classes of people:

- consumers and creditors bear the solvency risk of the company; and
- revenue authorities, who are concerned about excessive interest deductions.

---

1 See the Hon. Peter Dutton MP, Minister for Revenue and Assistant Treasurer, Media Release 12 September 2007, no. 114.

3.8 Thin capitalisation rules are applied to determine an upper level of debt above which income tax deductions for interest payments are denied. They are designed to ensure that Australian and foreign-owned multi-national entities do not allocate an excessive amount of debt to their Australian operations. It operates to limit the deductibility of interest payments when debt exceeds certain thresholds.[2] As the explanatory memorandum states, the thin capitalisation regime:

> …is designed to ensure that Australian and foreign-owned multinational entities do not allocate an excessive amount of debt to their Australian operations. It does this by disallowing a proportion of otherwise deductible finance expenses (eg, interest) where the debt used to fund the Australian operations exceeds certain limits.[3]

Proposed modifications

3.9 Under the existing income tax arrangements there exists an incentive to use debt over equity for financing investment and business activity, and to maximise debt deductions in Australia.

3.10 Under the modified thin capitalisation rules a threshold will be established beyond which an entity will be subject to the denial of debt deductions. However, this threshold does not represent an absolute limit as entities can maintain higher gearing ratios where they are prepared to forgo debt deductions for that proportion of their debt in excess of the statutory gearing limits.

3.11 Assets and liabilities which will not be recognised for thin capitalisation purposes include: deferred tax assets and liabilities (within the scope of Australian accounting standard *AASB 112 Income Taxes*) and assets and liabilities arising from defined benefit plans (within the scope of Australian accounting standard *AASB 119 Employment Benefits*).

3.12 There are circumstances in which particular entities may choose to recognise or revalue certain intangible assets, contrary to the relevant accounting standard. This primarily relates to intangible assets within the scope of Australian accounting standard *AASB 138 Intangible Assets*.

3.13 The committee did not receive any submissions relating to this Schedule.

---

2 Australian Treasury, 'Discussion paper—Thin Capitalisation: application of accounting standards', 1 November 2006, http://www.treasury.gov.au/documents/1179/PDF/Discussion%20paper%20-%20final.pdf

3 Explanatory memorandum, paragraph 2.7.