Chapter
Thin capitalisation – modification of the rules in relation to the application of accounting standards for authorised deposit-taking institutions

Outline of chapter

1.1 Schedule TC to this Bill modifies the thin capitalisation rules contained within Division 820 of the Income Tax Assessment Act 1997 (ITAA 1997) in relation to the use of accounting and prudential standards for valuing certain assets of authorised deposit-taking institutions (ADIs).

1.2 This measure aims to adjust for certain impacts from the 2005 adoption of the *Australian equivalents to International Financial Reporting Standards* (AIFRS) on an ADI's thin capitalisation position. It does this by adjusting the application of accounting and prudential standard treatment of specified assets.

1.3 This chapter outlines the circumstances in which certain assets are to be recognised by particular entities for thin capitalisation purposes. The relevant assets are:

- treasury shares;
- the business asset known as excess market value over net assets – the 'EMVONA' asset; and
- capitalised software costs.

1.4 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

Context of amendments

1.5 The thin capitalisation rules in Division 820 are designed to ensure that Australian and foreign-owned multinational entities do not allocate an excessive amount of debt to their Australian operations thereby inappropriately reducing their Australian profits and tax. 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. The allowable level of debt for an ADI is calculated by reference to a minimum amount of equity capital.

1.6 The thin capitalisation rules use the accounting standards as the basis for the identification and valuation of assets, liabilities and equity capital for thin capitalisation purposes. Prior to 2005 the relevant accounting standards were *Australian Generally Accepted Accounting Principles* (AGAAP). However, from 1 January 2005 AGAAP were replaced by AIFRS. The adoption of AIFRS is regarded as aligning Australia more closely with international accounting practice.

1.7 Transitional provisions were introduced to insulate affected entities, including ADIs, from potential adverse impacts on their thin capitalisation position from the 2005 adoption of the AIFRS. These transitional arrangements enabled entities to elect to apply the accounting standards as they existed immediately before 1 January 2005 (rather than the AIFRS) for a period of up to four income years from the first income year commencing on or after 1 January 2005. These arrangements are set out in section 820-45 of the *Income Tax (Transitional Provisions) Act 1997*.

1.8 Under subsection 820-45(4) of the *Income Tax (Transitional Provisions) Act 1997*, if an ADI makes a choice to use accounting standards that existed before 1 January 2005 (for an income year), the ADI must also choose to use the prudential standards in force under the *Banking Act 1959* immediately before 1 January 2005 (rather than the current prudential standards) for calculating amounts applicable to the ADI under Division 820.

1.9 The application of these transitional provisions began expiring from 1 January 2009.

1.10 The amendments in Schedule TC implement the Budget announcement of the former Assistant Treasurer and Minister for Competition Policy and Consumer Affairs in Media Release No. 048 of 12 May 2009. In that Media Release, the Government announced it would introduce changes to the thin capitalisation regime for ADIs.

1.11 The amendments effectively establish the framework to apply on expiration of the current transitional arrangements and will apply to relevant entities whether or not an entity elected to use the transitional provisions.

1.12 At the time AIFRS was adopted, certain impacts of the new standards for taxpayers subject to the thin capitalisation regime were expected, however other outcomes were unexpected and could not be considered at that time.

1.13 This measure does not reflect an intention to neutralise, for the purposes of the thin capitalisation rules, all differences in outcomes between the previous and current accounting standards. It is not intended to provide entities with scope to artificially inflate their asset base to support higher gearing levels inconsistent with the broader intent of this regime.

Summary of new law

1.14 For income years commencing on or after the 1 January 2009, entities will be able to deviate from the accounting standard treatment of certain assets and liabilities when doing their capital calculations.

Comparison of key features of new law and current law

New law	*Current law*
Treasury shares included in the calculation of adjusted average equity capital.	Where the transitional provisions no longer apply, treasury shares deducted from equity capital. This results in the treasury shares value not being included in adjusted average equity capital. Where the transitional provisions still apply, treasury shares are included in the calculation of adjusted average equity.
The business asset, excess market value over net assets (EMVONA) excluded from step 3 of the safe harbour calculation. EMVONA is not recognised as a prudential capital deduction.	Where the transitional provisions no longer apply, the business asset, excess market value over net assets (EMVONA) included in step 3 of the safe harbour calculation. EMVONA recognised as a prudential capital deduction. Where the transitional provisions still apply, the business asset excess market value over net assets (EMONVA) excluded from step 3 of the safe harbour calculation. EMVONA is not recognised as a prudential capital deduction.

Capitalised software expenses are excluded from step 3 of the safe harbour calculation. Capitalised software expenses are not recognised as a prudential capital deduction.	Capitalised software expenses are included in step 3 of the safe harbour calculation. Capitalised software expenses are recognised as a prudential capital deduction.

Detailed explanation of new law

Treasury shares

1.15 Treasury shares are equity instruments that an entity acquires in itself (AASB 132 *Financial Instruments Presentation*). The amount of treasury shares held must be disclosed separately either on the face of the balance sheet or in the notes (AASB 101 *Presentation of Financial Statements*).

1.16 The circumstances in which an entity can hold shares in itself are strictly limited under the *Corporations Act 2001*. However, within these limits it is common business practice for the subsidiary of a bank to invest in the parent company, Two examples of an entity holding treasury shares are:

- life insurance subsidiaries (as trustees for life insurance statutory funds) holding equity in the parent bank on behalf of policyholders; and

- employee share plan arrangements where entities hold parent company shares as part of the consolidated group's employee share plan arrangements.

1.17 Under AASB 1038 *Life Insurance Business*, issued 17 November 1998, direct investments in a particular bank's shares by that company's life insurance statutory funds are recognised in the group's balance sheet at market value (that is, recognised within investments relating to the life insurance business). Consequently, under this accounting standard, this amount was included in the calculation of adjusted average equity capital.

1.18 Section 820-300 is modified so that for the purposes of calculating the adjusted average equity capital for an income year, treasury shares in the entity are to be treated as included in the ADI equity capital to the extent that those shares are part of the entity's eligible Tier 1 capital ***[Schedule TC, Item 1]***. These treasury shares are shares held by a group member for the benefit of third parties (that is policy holders) or where the shares offset the accrued expense of a share-based compensation scheme (as described in paragraphs 34 and 35 of Australian Prudential Standard 111 *Capital Adequacy: Measurement of Capital* issued January 2008).

1.19 The amendment substantively retains the treatment, for thin capitalisation purposes, of a direct investment in a particular bank's shares by that company's life insurance statutory fund which existed immediately before 1 January 2005.

Excess market value over net assets (EMVONA)

1.20 Under AGAAP and AASB 1038 *Life Insurance Business*, a life insurer was able to recognise as a separate asset (in its consolidated financial statements) the excess of the market value of interests in subsidiaries over the net amount of the assets and liabilities of those subsidiaries as recognised in the consolidated financial statements. This was known as the 'EMVONA' asset.

1.21 EMVONA is made up of acquired goodwill arising from acquisitions of subsidiaries, including the value of new business expected to be written in the future (VNB), the value of business in force at the time of acquisition (VBIF), and any increases in the value of VNB and VBIF since acquisition.

1.22 This amendment reduces the minimum amount of equity capital that an ADI must hold by the amount of goodwill or intangible assets arising on acquisition of a subsidiary which relate to the excess of the net market value of the interest in the subsidiary over the net amount of that subsidiary's assets and liabilities. ***[Schedule 1 Item 2]***

Capitalised software expenses

1.23 The amendment substantively retains the treatment of capitalised software costs under the accounting and prudential standards that existed immediately before 1 January 2005. The safe harbour method statement in section 820-310 is amended for these purposes.

1.24 Specifically, the effect of the amendment is that intangible assets comprising capitalised software expenses are not added back in determining the safe harbour capital amount which would otherwise be required by the new prudential standards. ***[Schedule 1 Item 2]***

Requirement to use accounting standards

1.25 Section 820-680(1) requires an entity to comply with the accounting standards in identifying its assets and liabilities and in determining the value of its assets, liabilities and equity. The note following subsection 820-680(1) refers to provisions which modify this requirement. That note is amended to include the changes made by this Schedule to the treatment of the 'EMVONA' asset. ***[Schedule 1 Item 3]***

Application and transitional provisions

1.26 The amendments made by this Schedule apply to assessments for each income year starting on or after 1 January 2009 marrying up with the end of the transitional arrangements in the *Income Tax (Transitional Provisions) Act 1997*. ***[Schedule 1 Item 4]***

Consequential amendments

1.27 There are no consequential amendments.