Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas

Changes in tax law – does fair value still matter?

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Introduction

A key measure of the 2018-19 Federal Budget was tightening Australia's thin capitalisation regime by requiring entities to align the value of their assets for thin capitalisation purposes with the value included in their financial statements. This had never been previously required. After much ado, lapsed Parliamentary changes and a shock election result, the proposed changes are still expected to come into effect for income tax years commencing on or after 1 June 2019.

So, to continue to even maintain existing thin capitalisation positions, assets must now be shown in audited accounts at fair value. This presents a number of practical challenges.

What are the thin capitalisation rules?

The thin capitalisation regime refers to tax rules that essentially limit and cap the amount of debt-related deductions an Australian taxpayer can claim for tax purposes. Without such rules, multinational entities could artificially gear their Australian activities to erode the Australian tax base. Where an entity exceeds the thin capitalisation limit, deductions in relation to the excess are denied for tax purposes. The regime comprises three independent tests:

1 The safe harbour debt test - for most entities, this caps the level of debt in their Australian activities at 60% of the value of their Australian assets.
2 The worldwide gearing test - this caps the level of debt for the Australian activities at the consolidated group debt-to-equity ratio (rather than 60%).
3 The arm's length debt test - this caps the level of debt for the Australian activities at a level which an independent entity in similar circumstances could achieve in the open market.

By far the most frequently relied on test is the safe harbour debt test: it is the application of this test that is most affected by the proposed changes.

Why do the changes matter?

The changes matter because they overturn a long-standing legislative concession that enables entities to use a different valuation methodology for their assets for thin capitalisation purposes to the value reflected in their financial statements.

Since the inception of the thin capitalisation regime in 2001, the safe harbour debt amount has relied exclusively on the Australian Accounting Standards (**AAS**), with some modifications. The value of assets as determined by the AAS is used to determine the relevant asset base for calculating the debt-to-equity ratio under the safe harbour, with 'assets' being the relevant proxy for an entity's equity. However, a key feature of the thin capitalisation regime has been that assets and liabilities be recognised and valued *in accordance with* the accounting standard (rather than reflected in the statutory accounts of the relevant entity). The proposed change overturns this long-standing legislative concession that entities can notionally revalue assets for tax purposes only. This includes the ability to recognise the value of certain assets for thin capitalisation purposes that are not recognised in the AAS. This will no longer be available under the changes.

The concessions had practical importance for most taxpayers on the basis that:

- revaluation of assets (normally from historic cost to fair value) in financial statements can create uncertainty and introduce volatility into an entity's financial performance that may be misinterpreted by market analysts, whereas historic cost is generally preferred for being less volatile, reflecting only periodic depreciation and impairment. This is especially problematic for Australian multinationals where the financial statements used for thin capitalisation calculations are likely to be the company's consolidated public accounts. This is generally of lesser concern to inbound investors where the financial statements of their Australian operations are not directly disclosed to the market.
- AAS do not allow internally generated intangible assets to be recognised under AASB 138 *Intangible Assets*. For many Australian multinationals, brand and other internally generated intangibles are significantly valuable but will no longer form part of their asset base for thin capitalisation purposes. This will be particularly problematic for certain taxpayers as in the 'digital economy' the key drivers of economic growth are less likely to be recognised in financial statements due to a lack of an active market. The Federal Government previously accepted that such assets should form part of an entity's thin capitalisation asset base in amending the rules to ensure these types of assets could continue to be recognised and valued for thin capitalisation purposes on transition from the previous Australian Generally Accepted Accounting Principles (GAAP) to the Australian equivalents of International Financial Reporting Standards (AIFRS) in 2005.

Companies that previously accessed concessions will need to consider the effect of the proposed changes and whether previously relied on 'notional' revaluations to fair value used only for thin capitalisation purposes are appropriate to be reflected in their actual statutory accounts. Put simply, companies that have very valuable brands or intellectual property could previously take credit for their value in tax calculations. This no longer applies. Accounting standards do not allow internally generated intangibles to be recognised at fair value in the financial statements. This fundamental shift may leave some companies exposed to a significant additional tax impost.

So when can companies use fair value to account for assets in their financial statements?

Fair value in accounting standards is relatively simple: there is clear guidance on when fair value accounting can be applied and for what assets. Critically, though, moving to using fair value models in statutory accounts brings other burdens. For example, fair values may only be used for certain assets, it is not static and must be updated regularly, which is not a simple process. External valuers may be needed to establish robust support for amounts reported, and sceptical auditors will likely resist optimistic internal valuations.

So what actually is fair value? Accounting standards define it as a market price that would be paid between a buyer and seller in the normal course of business. Fair value may be used for initial measurement of an asset or on an ongoing basis.

Critically, the accounting standards also limit when fair value may be used, with only certain assets allowed to be carried at fair value in an accounting balance sheet. Other assets must be carried at historical cost. Table 1 lists the asset classes that can be measured at fair value and the rules that apply.

Table 1. Class of assets that may be measured at fair value

Class of asset(s)	AASB	Comments
Property, plant and equipment	116	• These may be measured at cost or fair value as a free choice of accounting policy. • The policy must be applied to an entire class of assets if a fair value model is used. There is no requirement to apply fair value to all assets beyond those in a class. This provision is very useful in that, depending on how classes are defined, fair value accounting may be practically applied without the need to undertake an expensive and lengthy exercise over a company's entire asset base. • Accounting standards require revaluations to be performed when significant changes in values arise and indicate that for assets with infrequent changes in value, a valuation may need to be performed every 3 or 5 years. In our experience, most companies with assets at fair value would not undertake revaluations more frequently, but rather amend inputs to a model for foreign exchange etc. between revaluation dates. • One area of controversy has been mineral properties. No clear guidance exists as to whether mining tenements are, in fact, PP&E and eligible for revaluation. Care should be taken if considering a revaluation on such a basis. Neither the ATO nor

Class of asset(s)	AASB	Comments
		accounting standards have given certainty on whether the value of mineral properties comprises PP&E, an intangible or inventory within the ground in some form. • Assets within a class may be revalued on a rolling basis rather than the entire class being revalued at a single date. • Neither the ATO, accounting or auditing standards require an external valuation to be obtained. In our experience, it is likely, however, that auditors may insist on external valuations for material assets at least initially or on a rolling basis. Desktop valuations generally suffice for other dates or types of assets.
Intangible assets	138	• Cost or fair value model policy choice available for internally generated assets. • Accounting only permits revaluation basis to be used for intangibles with an active market. Practically, active markets do not exist - at least in Australia. Taxi licences, which were historically actively traded, no longer qualify after the rise of Uber given the lack of recent sales.
Investment properties	140	• Cost or fair value model policy choice available as a free choice. • As values may change, expect to update valuations annually. • The valuation may be conducted internally using a valuation model or with the assistance of an expert. In practice, companies would establish a model: for example, using a rental multiplier and updating it using comparable industry benchmark rental yields annually.

Class of asset(s)	AASB	Comments
Exploration and evaluation assets	6	• Cost or fair value model policy choice available as a free choice. • Once elected, then fair value periodically required and cannot revert back to cost. • When the technical feasibility and commercial viability of extracting a mineral resource are demonstrable, an exploration and evaluation asset is reclassified to property, plant and equipment or intangible assets. The provisions of AASB 116 or AASB 138 apply to these assets from that point. • In practice, there is little to be gained by adopting a fair value model as the designation must cease once production starts. As such, the significant uplift in value expected for a successful property happens after exploration and evaluation classification ceases.
Right-of-use assets arising under leases	AASB 16	• Cost or fair value model policy choice available if right-of-use assets relate to a class of property, plant and equipment for which the lessee has elected to apply the revaluation model. • The policy must be applied on all right-of-use assets within the class if the fair value model used. • Cost or fair value model policy choice available if right-of-use assets relate to investment property.
Agriculture	141	• Biological assets must be measured at fair value less costs to sell. • Harvested agricultural produce measured at fair value less costs to sell at the point of harvest.
Business combinations	3	• Accounting standards insist on a one-off revaluation of acquired business assets to fair value. This applies to all assets including intangible assets that otherwise might be ineligible. • Crucially, this revaluation only occurs at the time of the acquisition, with no provision in the standard to update values further.

Class of asset(s)	AASB	Comments
Business combinations under common control	3	• A business combination is a 'common control combination' if the combining entities are ultimately controlled by the same parent. • Internal restructures and re-organisations all fall into this category. These are exempted from normal business combination guidance as otherwise companies could simply restructure continuously to recognise new goodwill and other uplifts in intangible values. • For business combinations under common control, a policy choice exists to measure the assets of the acquiree either at fair value using the purchase method (applying business combination accounting under AASB 3) or at the previous carrying amount. This may still apply but only in very limited circumstances when the combined business is held by a parent outside Australia. For example, USA Parent may own Australia 1 and Australia 2. Australia 1 then acquires Australia 2. This could be an instance where business combination accounting is eligible, even though Australia 1 and Australia 2 are within a group. However, if Australia Parent owned Australia 1 and Australia 2, a similar combination would not be eligible as the consolidated Australian group has not changed.
Interests in joint ventures and associates	11 128	• Purchased interests in joint ventures are measured at cost. • However, if a joint venture is formed by contributing a subsidiary, then that subsidiary is first remeasured to fair value. For example, if Company A and Company B combine their businesses in NSW and WA in a new joint venture, each would remeasure their original businesses to fair value when forming the joint venture. The exact amount may vary depending on the nature of the arrangement but there is a one-off remeasurement to fair value.
Financial assets	9	• Financial assets must be measured at either amortised cost or fair value, depending on the features of the asset and the entity's business model. • Only investments in ordinary loans are measured at cost. • All other financial assets are measured at fair value. This would include shares, derivatives and debt instruments that have complex features.

However, opportunities remain

Making sure that the value of assets is maximised on the balance sheet is an important part of ensuring entities are not adversely affected by thin capitalisation. As alluded to above, the drawbacks of carrying assets at fair value need to be considered when deciding whether to maximise your thin capitalisation position. For ASX listed companies, a wholesale change to fair value accounting is simply not practical. For others, such as Australian subsidiaries of multinationals, fair value may be a genuine accounting policy alternative that should be carefully considered.

Taxpayers likely to gain the most significant benefits of carrying assets at fair value are:

- Foreign consolidated multinationals - as the relevant accounts are only those of the Australia tax group, any adverse accounting effects of carrying assets at fair value will be negated as a result of group accounting consolidation.

- Privately held entities - as the relevant accounts are not subject to market scrutiny, volatility in the fair valuation of assets is of a lesser concern. However, consideration needs to be given to other commercial effects of injecting volatility into asset values. No board or shareholder appreciates the risk of a fair value loss in their income statement should conditions change adversely.

- Those with long-held capital intensive investments - traditionally the value of long-life capital assets (such as PP&E) is amortised over time and therefore the balance sheet may not reflect the actual market value of the assets. An LNG plant today, with gas prices on the rise, may well be worth far more than the cost of construction.

- Those undertaking green-field investments in Australia - tax modelling during the investment decision phase can provide the opportunity to determine whether an investment will be adversely affected over its life-cycle and whether assets should be carried at fair value. Applying an accounting policy of fair value in financial statements is much easier at inception. Changing policy for the financial statements of an operating business is not easy.

- Entities acquiring Australian businesses - purchase accounting will always require fair value to be applied initially. The use of an Australian acquisition vehicle will see those fair values recognised in the highest level of consolidated Australian financial statements prepared by a group.

So what does all this mean?

- Existing tax consolidation positions that depended on 'notional' fair values of assets must fundamentally be revised.
- Applying fair value in financial statements is not simple - the accounting standards do limit assets that may be carried at fair value - with intangibles being the most critical such prohibition.
- Taxpayers will need to comprehensively revise existing models and make decisions now if accounting policies are to be amended, and
- The arm's length debt test may well be the most practical alternative. Taxpayers will need to prepare early.