In detail

Detailed information about debt and equity tests.

Guides

Information guides about debt and equity tests.

Debt and equity tests: overview

Work out how an interest is classified for tax purposes under the debt and equity test rules.

82007

Debt and equity tests

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The tests for debt and equity interests determine whether a particular interest is a debt interest or an equity interest.

Rules determining what is equity in a company and what is debt in an entity for tax purposes are contained in Division 974 of the *Income Tax Assessment Act 1997*.

The debt or equity classification of an interest is relevant for certain tax purposes, including:

- identifying debt for thin capitalisation purposes
- identifying debt for the consolidation measure
- determining whether certain returns may be subject to interest withholding tax or dividend withholding tax.

The debt and equity tests determine whether a return on an interest in an entity may be frankable and non-deductible (like a dividend) or may be deductible to the entity and not frankable (like interest).

If an interest passes one or more items of the equity test table, then, subject to the overriding operation of the debt test, it will be an equity interest.

If the equity interest is classified as a non-share equity interest, a non-share capital account is maintained. In determining what is a debt interest, the rules use a single organising principle - the effective obligation of an issuer to return to the holder an amount at least equal to the amount invested. The rules consider the substance of the arrangement, and the classification is not necessarily determined just by the legal form of the arrangement.

There is a tiebreaker test that applies to interests that pass both the debt and equity tests. Where both the debt and equity tests are satisfied, the tiebreaker test provides that the interest is a debt interest.

See also:

- Guide to the debt and equity tests.

Special applications of the debt and equity measures

At call loans

An 'at call' loan (or related party 'at call' loan) is a loan to a company, by a connected entity (including a controlling shareholder or director), that does not have a fixed repayment term and is repayable on demand by the connected entity (that is, the lender).

If a company has a GST turnover of less than $20 million, there is a carve-out - which means related party ‘at call’ loans will be treated as being debt interests rather than equity interests.

For a more detailed explanation of connected entity at call loans (also referred to as 'credit shareholder loans' or 'related party loans'), refer to the debt and equity tests: guide to 'at call' loans.

Non-equity shares not to give rise to a capital gains tax event

The issue of non-equity shares does not give rise to a capital gains tax (CGT) event by virtue of sections 104-35 or 104-155 of the *Income Tax Assessment Act 1997*.

Importance of debt and equity measures

The debt and equity rules aim to improve certainty in the tax law by establishing tests that provide a clearer and more coherent distinction between equity and debt interests.

Impacts on taxpayers

The major impact will be on financial institutions, life insurers, superannuation funds and large corporates. Small business and individuals are affected to a lesser extent.

Legislation

The primary legislative reference is *Division 974 of the Income Tax Assessment Act 1997*.

Next step:

- Debt and equity tests: guide to the debt and equity tests

16616

Our commitment to you

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If you follow our information and it turns out to be incorrect, or it is misleading and you make a mistake as a result, we will take that into account when determining what action, if any, we should take.

Some of the information on this website applies to a specific financial year. This is clearly marked. Make sure you have the information for the right year before making decisions based on that information.

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