

## **Ruling Compendium – TD 2009/21**

This is a compendium of responses to the issues raised by external parties to draft TD 2009/D8 – Income tax: to obtain a deduction under section 25-90 of the *Income Tax Assessment Act 1997* for a cost in relation to a debt interest does the taxpayer have to actually derive a dividend to which section 23AJ of the *Income Tax Assessment Act 1936* applies in the same income year as that in which the cost is incurred?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

### **Summary of issues raised and responses**

<b>Issue No.</b>	<b>Issue raised</b>	<b>Tax Office Response/Action taken</b>
1	The test for deductibility under 25-90 of the <i>Income Tax Assessment Act 1997</i> (ITAA 1997) is the same as the test for deductibility under section 8-1 of the ITAA 1997	<p>The Tax Office does not consider that the tests for deductibility under section 25-90 of the ITAA 1997 are inherently the same as the tests for deductibility under section 8-1 of the ITAA 1997.</p> <p>In the Tax Office's opinion section 25-90 of the ITAA 1997 is not simply intended as a modification to section 8-1 of the ITAA 1997 as is the case with section 25-85 of the ITAA 1997 (which was introduced into parliament at the same time as section 25-90 of the ITAA 1997). Rather section 25-90 of the ITAA 1997 is intended to be a specific deduction provision with its own unique context and wording.</p> <p>The use of different words within the provisions restricts the ability for section 8-1 of the ITAA 1997 to provide interpretive assistance.</p> <p>The issue that needs to be determined is whether there is a sufficient connection between the derivation of section 23AJ dividends<sup>1</sup> and the debt deductions. As the High Court observed in <i>FC of T v. Day</i> ((2008) 236 CLR 163 per Gummow, Hayne, Heydon and Kiefel JJ at [30]) even when dealing with section 8-1 of the ITAA 1997 itself '[c]ases are helpful to show the connection found on the facts there present, but not always to explain how the search for the requisite connection is to be undertaken'.</p>

<sup>1</sup> A 'section 23AJ dividend' is a reference to a dividend that satisfies all of the criteria in section 23AJ of the *Income Tax Assessment Act 1936*, which provides for certain foreign dividends to be non-assessable non-exempt.

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1 cont		Further, the connection required by section 25-90 of the ITAA 1997 is to a very specific class of income so the inquiry is necessarily different as a practical matter. The final Determination further explains this in footnote 3.
2	It should be presumed that there will be an expectation of a section 23AJ dividend because shares by their very nature are inherently capable of generating dividends.	Section 25-90 of the ITAA 1997 requires a nexus between the loss or outgoing and a section 23AJ dividend, not between the loss or outgoing and the holding of shares. The Commissioner agrees that most shares are inherently capable of producing dividends, and are generally acquired, at least in part, for the objective purpose of deriving such dividends. However, the application of section 25-90 of the ITAA 1997 arises in the context of section 23AJ dividends, which require shareholdings of a particular kind, being non-portfolio shareholdings. It cannot be assumed, therefore, that the holding of shares will necessarily result in the derivation of dividends that are section 23AJ dividends. In addition, non-portfolio shareholdings will often be part of larger financing arrangements which may serve a purpose other than the earning of dividends. Therefore the presumption that the shares are held with the intention of earning section 23AJ dividend income does not necessarily carry as much weight as in the case of a portfolio investor.
3	Application of the reasonable expectation test should be based on the facts and circumstances: intention and motive are not relevant considerations.	While the following statement in TR 95/25 was made in the context of section 8-1 of the ITAA 1997 and section 51 of the ITAA 1936 it is considered to express a more generally applicable principle about the proper characterisation of the nexus between interest expenses and the derivation of income and as such is of some relevance in interpreting section 25-90 of the ITAA 1997: The character of interest on money borrowed is generally ascertained by reference to the objective circumstances of the use to which the borrowed funds are put by the borrower. However, regard must be had to all the circumstances, including the character of the taxpayer's undertaking or business, the objective purpose of the borrowing, and the nature of the transaction or series of transactions of which the borrowing of funds is an element. In some cases, the taxpayer's subjective purpose, intention or motive may be relevant in deciding the deductibility of interest.

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4	It should not be necessary to undertake an assessment of the likelihood that a dividend will actually be paid. Use of the word 'potential' in paragraph 12 of the draft Determination suggests that this is necessary.	The final Determination is concerned with one aspect of the requirement in the legislation that there be a nexus between the deriving of a section 23AJ dividend and the debt deduction. Whether such a nexus exists is a question of fact, and in that context the likelihood of a dividend being derived is a relevant, arguably a determinative, consideration. Consequently, the 'potential' for the derivation of the dividend is an important consideration.
5	It should be sufficient that there was a reasonable expectation of section 23AJ dividends when the obligation to pay borrowing costs arose: it should not need to be tested annually.	In the Tax Office's opinion whether a cost is incurred in deriving a section 23AJ dividend is essentially a question of fact. Basing a decision as to deductibility purely on the original application of the borrowed funds is to ignore other potentially relevant facts. Changes in the facts may materially alter the nexus between the debt deduction and the derivation of section 23AJ dividends over the term of the loan.
6	It should be sufficient that interests previously (but no longer) held were capable of producing section 23AJ dividends, and that there was a reasonable expectation of section 23AJ dividends when the obligation to pay borrowing costs arose.	In the Tax Office's opinion whether a cost is incurred in deriving a section 23AJ dividend is essentially a question of fact. See response to Issue 5 for further details. Whether the interest continues to be held is relevant, though not necessarily conclusive, to the nexus between the debt deduction and the derivation of section 23AJ dividends.
7	The factors considered relevant to a reasonable expectation should be removed, or modified such that: <ol style="list-style-type: none"><li data-bbox="271 1065 923 1129">(1) there should be no requirement for the relevant interest to be held for the whole year</li><li data-bbox="271 1129 923 1192">(2) there should be no requirement for dividends to be paid out of retained profits</li></ol>	The factors are intended as an indication of the factors that would be expected to be present in order for there to be a reasonable expectation of a future section 23AJ dividend: <ol style="list-style-type: none"><li data-bbox="923 1065 1989 1160">(1) the final Determination has been amended to reflect that the expectation is that the interest is held at the time the cost is incurred, not for the whole income year</li><li data-bbox="923 1160 1989 1224">(2) there is no requirement for a dividend to be paid out of retained profits. The final Determination has been amended to clarify this</li><li data-bbox="923 1224 1989 1319">(3) where income on the presently held interest would not be a section 23AJ dividend, it would not usually be expected that there would be a future section 23AJ dividend.</li></ol>

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7 cont	(3) there should be no requirement for the interest to qualify for section 23AJ of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936) for the current year (eg less than 10% holding, convertible note that does not currently qualify for section 23AJ of the ITAA 1936 but will convert to shares that will qualify for section 23AJ of the ITAA 1936).	For example, if the current shareholding is 5%, in the absence of further information, there is no reasonable expectation of a future section 23AJ dividend. The word 'interest' rather than 'share' at paragraph 13 of the final Determination has been chosen to indicate that section 25-90 of the ITAA 1997 may apply to a broader range of circumstances than simply legal form shares.
8	Should refer to 'dividend' not 'distribution' in paragraph 13.	Agreed. Paragraph 13 of the final Determination has been amended.
9	The Determination should apply to dividends that are exempt under sections 23AK and 23AI of the ITAA 1936.	The Determination is intended to deal with a specific technical issue: whether the provision requires a 'temporal' nexus between the derivation and the debt deduction. Because sections 23AI and 23AK of the ITAA 1936 involve their own distinct statutory contexts it is considered preferable to limit the Determination to section 23AJ of the ITAA 1936. Additionally, the question of a temporal nexus has arisen almost exclusively in the context of section 23AJ of the ITAA 1936.
10	Concern with the reference to 'the mischief to be remedied' in paragraph 6.	The fundamental purpose of statutory interpretation is to determine the Parliament's purpose in enacting a particular provision. The purposive approach to statutory interpretation had its origins in the 'mischief rule' (Pearce, DC and Geddes, RS, 2006, <i>Statutory interpretation in Australia</i> , 6 <sup>th</sup> edn, Butterworths, Australia, p. 27). It is well established that the mischief intended to be remedied by an enactment is a relevant part of the context to be taken into account in interpreting a provision, and for this purpose, reference may be made to extrinsic materials ( <i>C/C Insurance Ltd v. Bankstown Football Club Ltd</i> (1997) 187 CLR 384; 141 ALR 618).
11	Concern with reference to 'careful tax planning' in paragraph 9.	The reference to 'careful tax planning' reflects the Tax Office's understanding that the enactment of section 25-90 of the ITAA 1997 and the thin capitalisation rules was aimed in part at removing the need for certain types of tax planning. Reference to the relevant section of the explanatory memorandum has been included in paragraph 9 of the final determination to explain the use of this term.

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12	Concern with the intended scope of the reference to 'all the criteria in section 23AJ' in footnote 1.	Footnote 1 is simply intended to explain the use of the term 'section 23AJ dividend'. The wording of the footnote (footnote 2 in the final Determination) has been amended to clarify this.
13	Query as to the intended meaning of paragraph 3 of the draft Determination which provides that the determination does not address the question of the amount of the deduction.	As previously stated the Determination is concerned with one relatively limited aspect of the requirement in the legislation that there be a nexus between the deriving of a section 23AJ dividend and the debt deduction. As such the Determination does not deal with other technical issues that may arise when determining if a deduction is available under section 25-90 of the ITAA 1936. The paragraph merely highlights that this Determination does not purport to answer that question.
14	Concern that the interpretation requires tracing of the costs incurred to the particular investment.	Section 25-90 of the ITAA 1936 does not require the cost to be traced to a particular derivation of income. However, it does require a nexus between the cost and the process of deriving the relevant income. In order for this nexus to be satisfied, the cost must be able to be traced to a particular investment in order to determine whether the other conditions of section 25-90 of the ITAA 1936 are satisfied.
15	The determination should explain that a deduction may be available under section 8-1 of the ITAA 1997 if a deduction is not available under section 25-90 of the ITAA 1997.	The potential application of section 8-1 of the ITAA 1997 would raise a number of technical and factual issues, some of them potentially complex, and it is considered preferable to limit this Determination to section 25-90 of the ITAA 1997. There is already extensive Tax Office guidance on the application of section 8-1 of the ITAA 1997.