TR 92/D24 - Income tax: application of sections 51, 23AJ, 79D and Part IVA to the deductibility of interest expense of a resident company

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Draft Taxation Ruling

Income tax: application of sections 51, 23AJ, 79D and Part IVA to the deductibility of interest expense of a resident company

other Rulings on this topic
IT 2606

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What this Ruling is about

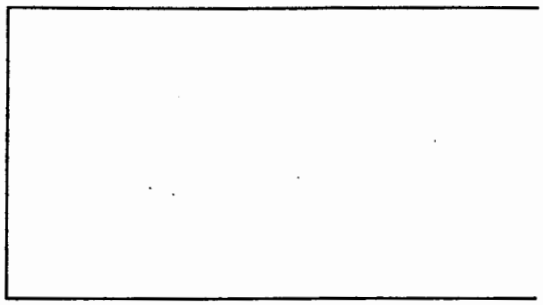
1. This Ruling provides guidelines for how Part IVA of the *Income Tax Assessment Act 1936* is to be applied in determining whether a deduction is allowable for certain interest expense incurred by a resident company.

2. The interest expense relates to loans taken by a company to acquire shares in foreign companies in a way that is claimed to avoid the operation of section 79D.

3. The Ruling considers, in particular, the case where a resident company (the parent) in a company group incurs interest expenses on money borrowed by the company for the purchase of shares in a foreign company. However, instead of investing directly overseas, the parent capitalises another resident company (the subsidiary) in the same company group. The subsidiary uses those funds to acquire shares in a non-resident company.

4. It may also be the case that the arrangements to acquire shares in the foreign company include special channelling of funds or the use of intra-group interest free loans to isolate the funds borrowed on which interest is paid from the funds purportedly used for the purchase of the shares.

5. The Ruling deals with the case where the shares acquired by the subsidiary could give rise to assessable foreign income in the form of dividend income. It also deals with the case where dividends received by the subsidiary on the shares acquired in the non-resident company would be exempt from income tax under section 23AJ and evidence shows that the real purpose of the arrangement is to avoid the application of the provisions of subsection 51(1) that deny a deduction



DRAFT TAXATION RULING TR 92/D24

We invite you to comment on this Draft Taxation Ruling. We are allowing six weeks for comments before we finalise the Ruling. If you want your comments considered, please get them to us within this period.

PLEASE ADDRESS ALL COMMENTS TO THE CONTACT OFFICER LISTED BELOW.

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COMMISSIONER OF TAXATION

for losses or outgoings to the extent that they are incurred in the production of exempt income.

6. The Ruling discusses whether we would apply the anti-avoidance provisions of Part IVA to deny deductions for the interest expense incurred by the parent company on the money borrowed to capitalise the resident subsidiary if the funds were effectively earmarked for the acquisition of shares in a non-resident company.

Ruling

7. In providing these guidelines, there is no intention of laying down any conditions to restrict officers in the exercise of any discretion. Each case must be decided on its merits.

8. It may be clear on the evidence that a company group designed and executed an integrated set of transactions that:

- set up the type of company structure whereby one resident company derives foreign income and another resident company incurs the interest expense in relation to funds that are effectively used to make the investments that give rise to the foreign income; and
- have as their real purpose the avoidance of the foreign loss quarantining provisions of section 79D.

9. A similar corporate structure may be set up under which one resident company in the group derives dividend income that is exempt from tax under section 23AJ and another borrows the funds that are used to make the investments that give rise to the exempt income. Evidence may show that the real purpose of this structure is to avoid the application of the provisions of subsection 51(1) that deny a deduction for losses or outgoings to the extent that they are incurred in the production of exempt income.

10. Depending on the facts of the case, Part IVA may be applied to deny a deduction for interest expense incurred by the parent company on money borrowed to capitalise a subsidiary that used the funds to acquire shares in a non-resident company. Part IVA will be applied where it would be concluded that the dominant purpose of the group in structuring the transactions in that particular way is to avoid the application of subsection 51(1) or section 79D in relation to the interest expense.

11. The temporary application of the funds for some other purpose does not preclude a finding that the funds were earmarked for the purchase of shares in foreign companies if that was the ultimate purpose of the borrowing.

12. The mere fact that the overall purpose of the set of transactions is the commercial purpose of acquiring shares in foreign companies will not preclude the application of Part IVA to the transactions.

Date of effect

13. The Ruling deals with the provisions of sections 23AJ, 51, 79D and Part IVA as they apply for the 1990-91 income year and for later years.

Explanations

Sections 51 and 79D

14. Section 79D has the effect that a resident taxpayer who derives assessable foreign income of a particular class of income for a year of income cannot claim a deduction for losses or outgoings incurred in the production of that assessable foreign income to the extent that those losses or outgoings exceed the income of that class. The amount of that excess can only be carried forward to later years of income to be deducted from assessable foreign income of the same class of income. Section 160AFD provides for the carry forward and deduction of the amount of that excess.

15. A consequence of section 79D is that losses or outgoings incurred in deriving foreign income cannot, in any event, be claimed as allowable deductions from Australian source income. Moreover losses or outgoings incurred in deriving foreign income of a particular class of income cannot be claimed as allowable deductions from assessable foreign income of another class.

16. This consequence is referred to as 'the quarantining of the deduction of losses or outgoings incurred in deriving foreign income of a particular class of income to foreign income of that class'. More generally, it is referred to as the 'quarantining of foreign losses'.

17. The following example illustrates the effect of section 79D.

Example 1

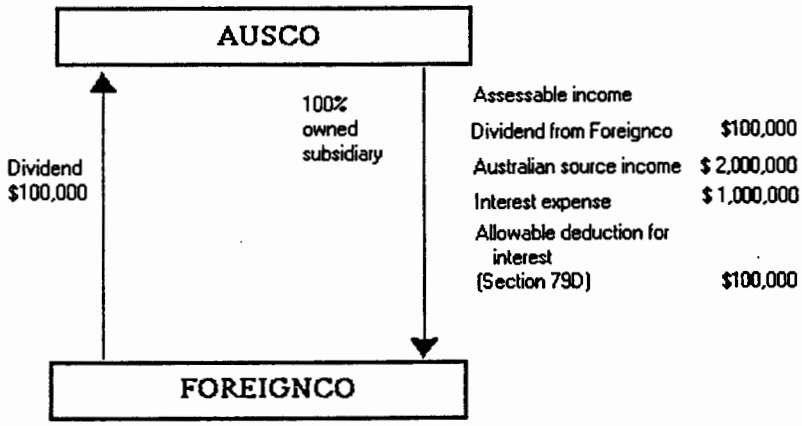
- Ausco has a wholly owned subsidiary company, Foreignco, in an unlisted (low-tax) country. Both companies close accounts to 30 June each year. Ausco had borrowed $10 million at a rate of interest of 10% to capitalise Foreignco.
- For the 1991-92 income year, Ausco derived from Foreignco dividend income of $100,000 that had to be included in Ausco's assessable income. It had no other foreign income for that year.

Ausco also derived assessable income of $2 million from business carried on in Australia.

- Ausco must include in its assessable income for the 1991-92 income year the dividend income of $100,000 and the assessable income of $2 million from business carried on in Australia. However, the effect of section 79D is that it can claim a deduction for interest expense of only $100,000 out of the total interest expense of $1 million incurred by it for that income year. This is on the assumption that no other losses or outgoings are incurred in deriving the dividend income or in carrying on business for the purpose of deriving that income. The balance interest expense of $900,000 cannot be deducted from Ausco's other assessable income for the 1991-92 income year. The interest expense of $900,000 can only be carried forward to later income years for deduction from the same class of foreign income to which the dividend belonged (i.e. modified passive income).

Schematic representation of Example 1

$1 million interest on moneys borrowed to capitalise Foreignco



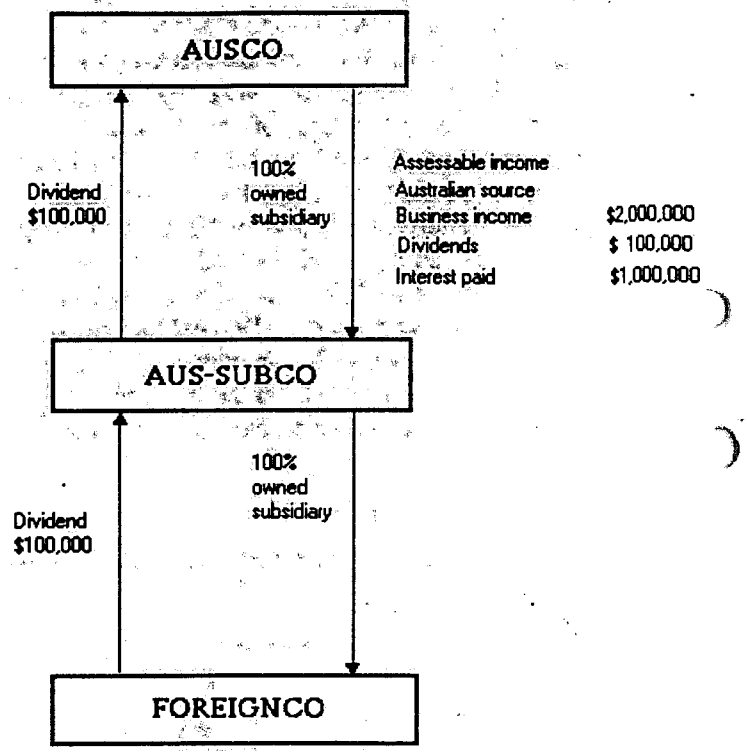
Example 2

The question has arisen whether this effect of section 79D could be avoided by simply interposing another resident company between Ausco and Foreignco such that:

- Ausco borrows $10 million at a rate of interest of 10 percent and uses the funds to capitalise Aus-subco; and
- Aus-subco then uses the funds to capitalise Foreignco.

Schematic representation of Example 2

$1 million interest on money borrowed to capitalise Aus-subco



18. The claim that the intended effect of section 79D is avoided ' this structure rests on two arguments.

- The first is that Ausco does not derive any foreign income and, consequently, section 79D does not apply to any deductions that would be available to Ausco.
- The second is that Aus-subco claims as allowable deductions only the expenses it incurs in deriving the foreign source income. As these expenses do not include the interest expense, section 79D will not deny a deduction for the interest expense incurred by Ausco.

19. The question has been asked, in particular, whether the anti-avoidance provisions of Part IVA would be applied to strike down the arrangement involving the interposition of a resident company between the resident parent company that incurs the interest expense and the non-resident company to which capital is contributed.

20. Whether a deduction is allowable for interest expense relating to share acquisitions in particular cases depends on the facts of each

case. The general principles that determine whether a deduction is allowable for that interest expense are set out in Taxation Ruling IT 2606. However, that Ruling did not deal with the effect of section 79D on the deductibility of the interest expense.

21. An interest expense that is an allowable deduction under subsection 51(1) for an income year may be reduced in the circumstances set out in section 79D.

22. The expression 'foreign income deduction' is defined in subsection 160AFD(9) in relation to a taxpayer for a class of assessable foreign income of a year of income. It means any deduction that, disregarding section 79D, is allowed or allowable from the assessable income of the year of income to the extent that it relates to assessable foreign income of that class for any year of income.

23. The proposition that the structure set out in Example 2 avoids the foreign loss quarantining rules of section 79D rests on the assumption that sections 51 and 79D must be applied to each taxpayer separately without regard to the interrelationship between the taxpayers.

24. The proposition rests equally on the assumption that the anti-avoidance provisions of Part IVA cannot be applied to this structure even if a conclusion could be drawn from the facts of the case that there is a scheme under which a tax benefit is obtained and the dominant purpose of the scheme is that of tax avoidance.

Sections 23AJ and 51

25. Section 23AJ exempts from Australian company tax non-portfolio dividends received by a resident company from a related foreign company that is a resident of a listed country. This exemption operates with effect from the 1990-91 income year of the resident company.

26. Where a resident company derives exempt income, subsection 51(1) denies that company any deduction from its assessable income for losses and outgoings incurred in deriving the exempt income.

27. A company structure of the type explained in Example 2 may also be put in place with the dominant purpose of breaking the connection between the derivation of exempt income and the incurring of the expenses relating to the derivation of that exempt income.

28. It has been submitted that subsection 51(1) will not be effective in denying a deduction for the interest expense in the context of a company structure of the type set out in Example 2. This submission rests on the same assumptions that underlie the proposition that that

company structure is effective in breaking the link between subsections 51(1) and 79D.

The effect of Part IVA

29. Part IVA is capable of being applied where three conditions are satisfied:

- there is a scheme entered into after 27 May 1981;
- a tax benefit was obtained; and
- it can be concluded that the scheme was entered into or carried out with the sole or dominant purpose of obtaining a tax benefit.

30. A scheme is defined in very wide terms to include any arrangement, whether express or implied and whether legally enforceable or not - subsection 177A(1). The definition includes a scheme even a course of conduct. The width of the definition indicates a legislative intent to give the term an extremely wide scope.

31. In Example 2 above, we are of the view that Ausco derives a tax benefit from the scheme. The scheme enables Ausco to obtain a deduction for an interest expense that, depending on the circumstances, it could otherwise not have obtained or obtained only in part. This benefit falls within paragraph 177C(1)(b) which treats a taxpayer as having obtained a tax benefit where a deduction is allowed to the taxpayer in a year of income and a whole or a part of that deduction would not have been, or might reasonably be expected not to have been, allowed for that year of income if the scheme had not been entered into or carried out.

32. Section 177D has the effect that Part IVA can only apply where it would be concluded that the scheme was entered into or carried out with the sole or dominant purpose of obtaining a tax benefit. This is a question of fact to be determined in each case having regard to the various matters specified in section 177D.

33. Subparagraph 177D(b)(iv) looks at the result in relation to the operation of the taxation law that would be achieved by the scheme in the absence of the provisions of Part IVA. The scheme by which a resident company is interposed between the company that borrows funds for the acquisition of shares in a foreign company and the foreign company in which the investment is made, is claimed to have the result that the interest expense, that may not be an allowable deduction if the investment is made directly by the borrower, now becomes an allowable deduction.

34. Under subparagraphs 177D(b)(v) and (vi), one relevant factor that is taken into account is whether the scheme changes the economic

circumstances of the company group taken as a whole except in so far as the tax consequences are concerned. Put another way, the question could be framed as follows:

> 'Does the company group benefit in any way, except for the tax saving, from interposing a resident company between the parent resident company and the overseas subsidiary?'

35. Cases have arisen where company groups have attempted to create separate streams of funds to support the argument that foreign investments were made using internally generated funds and not borrowings on which interest was paid. Having regard to the facts of the case, this may only further support a conclusion that the scheme had a dominant tax avoidance purpose.

36. Consequently, Part IVA could, depending on the facts of the case, be applied to deny a deduction for interest expense incurred by the parent company on money borrowed to capitalise a subsidiary that used the funds to acquire shares in a non-resident company.

37. In determining whether a particular borrowing was effectively earmarked for the purchase of shares in a foreign company, all the facts and circumstances relating to the transactions are to be taken into account. Part IVA could apply where it would be concluded on the facts that the transactions are structured in a particular way to avoid the application of section 79D.

38. Part IVA will be applied where it would be concluded on the facts of the particular case that the dominant purpose of the taxpayer in structuring the transactions in that particular way was to:

- avoid the application of subsections 51(1) and 79D in relation to the interest expense; or
- to break the connection between the derivation of exempt income under section 23AJ and the incurring of the interest expense in the acquisition of the shareholding that gave rise to the exempt income.

Commissioner of Taxation

6 August 1992

ISSN 0813 - 3662

Not previously released to the public in draft form

ATO references
NO 92/4132-9
BO

Price $0.80

FOI index detail
reference number

subject references
- anti avoidance
- dominant purpose
- foreign company
- interest expense
- quarantining of foreign losses
- scheme
- subsidiary

legislative references
- ITAA 23AJ; ITAA 51; ITAA 51(1); ITAA 79D; ITAA 160AFD

case references