TD 2004/D45 - Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the Income Tax Assessment Act 1997?

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Draft Taxation Determination

Income tax: can the assignment of an intra-group debt or income stream to an entity that is not a member of the consolidated group give rise to a debt interest for the head company of the group under Division 974 of the *Income Tax Assessment Act 1997?*

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. Yes.

2. Where a member of a consolidated group assigns a debt or an income stream owed to it by another member to an entity that is not a member of the group, the scheme will generally satisfy the definition of a 'financing arrangement' under section 974-130 of the *Income Tax Assessment Act 1997* (ITAA 1997) for the purposes of applying the debt test contained in section 974-20 of the ITAA 1997. Applying the single entity rule in section 701-1 of the ITAA 1997, the head company is taken to issue the interest at the time the member assigns the debt or income stream to the entity that is outside the group. Whether the other requirements of the debt test are satisfied is determined by reference to the facts and circumstances of each case.

The effect of the single entity rule

3. Section 701-1 of the ITAA 1997 provides that if an entity is a subsidiary member of a consolidated group for any period, it and any other subsidiary member of the group are taken for the core purposes (stated in subsection 701-1(2) and (3)) to be parts of the head company of the group, rather than separate entities, during that period ('the single entity rule').

4. The core purposes are, in brief, the working out of liability for income tax or tax loss for the relevant period in which any entity is a member of the consolidated group. In practical terms, this rule ensures that intra-group transactions between members of a consolidated group have no income tax consequences for the head company.

5. Under the single entity rule, an arrangement between members of a consolidated group is taken to be an arrangement between parts of the head company. Where such an arrangement involves a debt or a right to income, the obligations and payments will not be recognised and the tax law, including the debt-equity provisions in Division 974 of the ITAA 1997, cannot apply to them, as the head company is notionally both the debtor and the creditor as long as the arrangement subsists within the group.

6. If a debt or right to income held by the member creditor is subsequently assigned to an entity outside of the consolidated group ('non-member entity'), income tax consequences can arise for the consolidated group. Those consequences are viewed from the perspective of the head company as a result of the single entity rule. Notwithstanding that under the single entity rule the head company did not recognise the intra-group transaction between the members of the group, this underlying agreement may still be relevant in determining what rights and obligations the head company is taken (because of the single entity rule) to have entered into with the non-member entity.

Elements of the debt test in Subdivision 974-B of the ITAA 1997

7. For interests issued on or after 1 July 2001, Division 974 of the ITAA 1997 provides rules that determine the classification of that interest as either debt or equity for income tax purposes. In particular, it identifies the income tax treatment of distributions or returns made in respect of the relevant interest.

8. The debt test is contained in section 974-20 of the ITAA 1997. A scheme will satisfy the debt test in relation to an entity if:

- the scheme is a 'financing arrangement' for the entity (paragraph 974-20(1)(a));
- the entity, or a connected entity of the entity, receives, or will receive, a financial benefit or benefits under the scheme (paragraph 974-20(1)(b));
- the entity, or each of the entity and a connected entity of the entity, is under an effectively non-contingent obligation to provide a financial benefit or benefits to one or more entities after receiving its initial financial benefit (paragraph 974-20(1)(c));
- it is substantially more likely than not that the value of the financial benefits provided will be at least equal to the value of the financial benefits received (paragraph 974-20(1)(d)); and
- the value provided and received are not both nil (paragraph 974-20(1)(e)).

Definition of 'financing arrangement' for the purposes of applying the debt test

9. Subsection 974-130(1) of the ITAA 1997 defines a 'financing arrangement' as a scheme that is entered into or undertaken: to raise finance; to fund another scheme that is entered into to raise finance; or to fund a return payable under or provided by another scheme that is entered into to raise finance. Subsection 974-130(2) provides examples of schemes that are generally entered into or undertaken to raise finance while subsection 974-130(3) lists examples of schemes that are generally not entered into or undertaken to raise finance.

10. Thus, when determining whether a scheme is a 'financing arrangement', the question of whether it is 'entered into or undertaken to raise finance' will often arise. The word 'finance' is not defined and accordingly takes its ordinary meaning relevant to the

context. In this regard, the Australian Oxford Dictionary defines 'finance' as being 'the money resources of a nation, company or person' or the '[provision of] capital' for a person or an enterprise.

11. The Explanatory Memorandum (EM) to the New Business Tax System (Debt and Equity) Bill 2001 provides further context regarding the concept of 'the raising of finance'. At paragraph 2.7 it is stated that:

> The raising of finance generally entails *a contribution to the capital of an entity*, whether by way of money, property or services *in respect of which a return is paid by the entity*, be it contingent (connoting equity) or non-contingent (connoting debt). (Emphasis added)

12. Therefore, it is fundamental to the concept of a financing arrangement that there be a provision of resources for use in an entity's enterprise in exchange for some form of future return. It is important to note that the EM makes it clear that the concept of raising finance for the purposes of Division 974 is not restricted to only providing money – property or services may be provided as a substitute for money. This is reinforced by the definition of 'financial benefit' in section 974-160 of the ITAA 1997, which covers anything of economic value, including property or services. That is, the arrangement must, at the very least, involve the receipt of a financial benefit (as defined) and the contemplation of the provision of a financial benefit (as defined) on behalf of the entity being financed before it will be considered a financing arrangement.

13. Bearing this in mind, it has been said that a common, but not invariable, characteristic of an activity that has the subject of finance is the obligation *on each side* to pay money (*Re Ku-ring-gai Co-operative Building Society (No. 12) Ltd* (1978) 36 FLR 134 at 158 per Deane J). This suggests that a flow of funds between the relevant parties incorporating a claim to future cash flows of the financed entity is indicative of a financing arrangement. This is consistent with what is stated in paragraphs 10 to 12, although the debt-equity provisions also explicitly consider the provision of funding in money's worth (in the form of property of services). Further, the types of arrangement discussed in this paragraph are more reflective of debt financing.

14. The words of the definition of 'financing arrangement' suggest an element of purpose, as the test is whether the scheme is entered into or undertaken to raise finance etc. In this respect, the intentions of the parties to the arrangement may be relevant but are not determinative (paragraph 2.7 of the EM to the New Business Tax System (Debt and Equity) Bill 2001).

15. In light of the matters discussed here, each case must be viewed on the basis of its own facts and circumstances to determine whether or not a financing arrangement exists. Consistent with the object of the debt-equity provisions, the substance of the rights and obligations established by the arrangement must be taken into account (subsection 974-10(2) of the ITAA 1997).

Other requirements of the debt test

16. A 'financial benefit' is defined in section 974-160 of the ITAA 1997 as being anything of economic value including property or services. For the purposes of paragraph 974-20(1)(c), section 974-135 provides that an obligation will be an 'effectively non-contingent obligation' if, having regard to the pricing, terms and conditions of the scheme, the obligation is in substance or effect non-contingent. In turn, an obligation will be non-contingent if it is not contingent on any event, condition or situation other than the ability or willingness of that entity or connected entity to meet the obligation. Finally, for the purposes of paragraph 974-20(1)(d), the value of financial benefits provided is calculated in nominal terms if the performance period of the

scheme is less than 10 years; but if that period is more than 10 years, then the financial benefits are calculated in present value terms (section 974-35).

Application of the debt test to the assigned debt or income stream

17. Generally, outside of a consolidation context, the sale of a debt or assignment of income stream can be seen as the sale of an asset. A sale of an asset can be distinguished from an arrangement entered into to raise finance even if finance is involved in the payment of the price (*Re Ku-ring-gai Co-operative Building Society (No. 12) Ltd* (1978) 36 FLR 134 at 158 per Deane J). This is because the property and the payment of the price occur at the same time, with no party entitled to claim a future return on an amount.

18. However, pursuant to the single entity rule, the original arrangement entered into between the group members is not recognised as an asset or a liability of the head company. The act of assigning the intra-group debt or income stream outside of the group is the point in time when the head company is deemed to have incurred a set of obligations in return for the payment made by the non-member entity to secure those obligations.

19. The debt test can be applied to determine the income tax consequences for the head company of returns on an interest arising from the assignment of an intra-group debt or income stream to a non-member entity.

20. The nature of the rights and obligations between the head company and the non-member under the assignment are of relevance when applying the debt test. In ascertaining these rights and obligations for the purposes of working out the head company's income tax liability, any relevant matters under the original intra-group arrangement can be taken into account.

21. While each case will need to be considered in light of its own facts and circumstances, assignment of an intra-group debt or income stream will generally be a financing arrangement. Such a transaction exhibits indicia of raising finance. There are obligations on each side to pay money and the provision of funds to the head company gives rise to a claim on the head company's future cash flows on behalf of the non-member entity. Unless it can be established that the arrangement was not entered into to fund or contribute capital to the head company as representative of the consolidated group, the arrangement will be a financing arrangement.

22. The particular facts and circumstances of a given case will determine whether the other elements of the debt test are satisfied.

Example

Facts

23. *Aerial Co (Aerial) and Brilliant Co (Brilliant) are members of a consolidated group, with Heavy Co (Heavy) as the head company. On 1 July 2003, Aerial enters into a loan agreement with Brilliant under which Aerial lends Brilliant $20 million, and Brilliant agrees to repay the loan in 5 years' time. Interest is payable at a fixed rate.*

24. *Over the next year the market value of the debt decreases. During this time the consolidated group determines that it requires further funding for its activities, so on 1 July 2004 Aerial assigns its rights under the loan agreement to Outsider Co (Outsider), a non-member, for $15 million, with the effect that Aerial is under an obligation to pay Outsider $20 million in 4 years' time, plus interest.*

Application of the single entity rule

25. *As the original loan between Aerial and Brilliant is an intra-group transaction, it is treated for the purposes of working out Heavy's income tax liability as an arrangement between parts of Heavy. From Heavy's perspective, at this stage there are no interest payments or receipts that would result in a deduction or assessable income.*

26. *The debt test is applied when the debt (being the relevant scheme) is assigned by Aerial to Outsider on 1 July 2004.*

Application of the debt-equity rules in light of the single entity rule

27. *For the purposes of the definition of a debt interest, the relevant scheme is treated as coming into existence at the time of the assignment, as this is the time the arrangement with Outsider was entered into from the perspective of Heavy.*

28. *Under subsection 974-130(1)* of the ITAA 1997*, a scheme is a financing arrangement if it is entered into to raise finance for the entity (or a connected entity). From the facts, Heavy has entered into the scheme to raise finance. Heavy has received $15 million, being a financial benefit under the scheme. Heavy must repay $20 million under the scheme in 4 years' time which establishes a flow of funds between Heavy and Outsider.*

29. *Heavy's obligation is an effectively non-contingent obligation, being subject only to the passage of time. The interest obligations are also effectively non-contingent obligations. The value Heavy is required to provide under the scheme is therefore more than the benefit it has received, being $15 million. Both values are not nil.*

30. *Accordingly, the arrangement satisfies the conditions of the debt test.*

Example 2

Facts

31. *The facts are as in Example 1 except that Aerial entered into a 5 year agreement with Brilliant under which Aerial would lease property to Brilliant in return for yearly rental payments of $100,000 per year.*

32. *On 1 July 2004, Outsider pays Aerial $350,000 for the assignment of the remaining rental payments under the lease.*

Application of the single entity rule and the debt-equity rules

33. *The outcome in this example is identical to that in Example 1. The actual character of the payments in the transaction between the members of the consolidated group, Aerial and Brilliant, will not impact on the application of the debt-equity rules when the payment stream is assigned outside of the group because of the operation of the single entity rule.*

34. *For the same reasons provided in Example 1, the arrangement satisfies the conditions of the debt test.*

Date of Effect

35. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

36. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

Due date: **24 September 2004**

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Commissioner of Taxation
25 August 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

TR 92/20

Subject references:

- consolidation – tax liabilities
- debt equity borderline
- debt test
- financing arrangement
- single entity rule

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 701-1
- ITAA 1997 701-1(2)
- ITAA 1997 701-1(3)
- ITAA 1997 Div 974
- ITAA 1997 Subdiv 974-B
- ITAA 1997 974-10(2)
- ITAA 1997 974-20
- ITAA 1997 974-20(1)(a)
- ITAA 1997 974-20(1)(b)
- ITAA 1997 974-20(1)(c)
- ITAA 1997 974-20(1)(d)
- ITAA 1997 974-20(1)(e)
- ITAA 1997 974-35
- ITAA 1997 974-130
- ITAA 1997 974-130(1)
- ITAA 1997 974-130(2)
- ITAA 1997 974-130(3)
- ITAA 1997 974-135
- ITAA 1997 974-160

Case references:

- Re Ku-ring-gai Co-operative Building Society (No. 12) Ltd (1978) 36 FLR 134

Other references:

- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001
- The Australian Oxford Dictionary, Oxford University Press, South Melbourne

ATO references
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