TD 2008/D3 - Income tax: where a taxpayer has supplied or acquired property under an international agreement and that gives rise to a debt interest or an equity interest as defined for the purposes of Division 974 of the Income Tax Assessment Act 1997, does Division 974 bear upon the characterisation to be adopted for the purposes of the application of Division 13 of Part III of the Income Tax Assessment Act 1936 to the transaction?

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This document has been finalised by TD 2008/20.

There is a Compendium for this document: **TD 2008/20EC** .

Draft Taxation Determination

Income tax: where a taxpayer has supplied or acquired property under an international agreement and that gives rise to a debt interest or an equity interest as defined for the purposes of Division 974 of the *Income Tax Assessment Act 1997*, does Division 974 bear upon the characterisation to be adopted for the purposes of the application of Division 13 of Part III of the *Income Tax Assessment Act 1936* to the transaction?

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Ruling

1. No. Where it is relevant to distinguish between debt and equity in the application of Division 13 of Part III (Division 13) of the *Income Tax Assessment Act 1936* (ITAA 1936) to a supply or acquisition of property, the characterisation is not affected by Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997), should Division 974 of the ITAA 1997 have application to the scheme under consideration. Division 974 of the ITAA 1997 provides a test for determining whether an interest is to be treated as a debt interest or an equity interest for particular tax purposes that do not include the application of Division 13 of the ITAA 1936.

Date of effect

2. When the final Determination is issued, it is proposed to apply to years commencing 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.

Commissioner of Taxation
26 March 2008

Appendix 1 – Explanation

This Appendix is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Explanation

3. Division 13 of the ITAA 1936 permits the Commissioner to apply an arm's length consideration in assessing the correct amount of income or deductions in connection with the supply or acquisition of property by the taxpayer under an international agreement,[1] where it is considered that the parties were not dealing at arm's length with each other. Property for these purposes includes funds.[2]

4. Hence, where under an international agreement the taxpayer has received or made a contribution of funds, the question that can arise under Division 13 of the ITAA 1936 is whether a certain return would be expected on the funds, and if so, of what amount. The answer is determined by application of the arm's length principle, that is, by what might reasonably be expected under an agreement between independent parties dealing at arm's length.[3] In the application of this test it may, according to the particular circumstances, be important to establish whether the contribution of funds under the agreement was equivalent to equity rather than as a loan.[4] The factors that are taken into account include the legal effect of the transaction and other relevant matters.[5]

5. Division 974 of the ITAA 1997 provides tests to determine whether a scheme, or the combined operation of a number of schemes, gives rise to a 'debt interest' or an 'equity interest'. Subsection 974-10(1) of the ITAA 1997 provides that the test for determining whether a scheme (or schemes in combination) gives rise to a debt interest or an equity interest is relevant for 'particular tax purposes'. These particular tax purposes include whether any return payable on the interest may be deductible to or are frankable by the issuer. The Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 sets out the provisions dealing with international taxation to which the debt interest and equity interest definitions in Division 974 of the ITAA 1997 are relevant. No mention is made of Division 13, consistent with the intent that no provision limits the operation of Division 13 of the ITAA 1936.[6]

6. Accordingly, where an Australian resident company subscribes for securities issued by a non-resident subsidiary company, the treatment of the interest in the non-resident as a debt interest or an equity interest under Division 974 of the ITAA 1997 (should it be an instance where Division 974 of the ITAA 1997 also has application to a 'particular tax purpose') would not be considered relevant to the Division 13 of the ITAA 1936 issue of whether the return promised to the subscriber under the terms of the securities is an arm's length consideration.

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[1] Broadly 'international agreement' as defined in section 136AC of ITAA 1936 concerns agreements for the supply or acquisition of property by a non-resident otherwise than in connection with a permanent establishment of the non-resident in Australia, agreements for the supply or acquisition of property by a resident in respect of business outside Australia and agreements for the supply or acquisition of property in connection with a business conducted in an area covered by an international tax sharing treaty.

[2] 'Property' is defined in subsection 136AA(1) of ITAA 1936 and includes 'services' (also defined).

[3] See subsection 136AA(3) of the ITAA 1936.

[4] See Taxation Ruling TR 1992/11, Part C, paragraph 51.

[5] See Taxation Ruling TR 1992/11, Part C, paragraph 51.

[6] Subsection 136AB(1) of ITAA 1936 provides that nothing in the Act (other than Division 13) limits the operation of Division 13.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

Alternative views

7. It has been suggested that if a capital contribution is characterised as an equity interest under Division 974 this should dissuade the Commissioner from making a determination under Division 13 to impute interest income in respect of that contribution of funds.

8. In support of this argument reliance has been placed on paragraph 51 of Taxation Ruling TR 1992/11. Part C of TR 1992/11 deals with determining for Division 13 purposes whether an agreement that is in legal form a loan should be treated as equivalent to contribution of equity. Paragraph 51(c) of TR 1992/11 states:

> An example of a circumstance in which Division 13 would not be applied to impute interest income would be the case where the Commissioner is satisfied that the contribution of funds should be treated as equivalent to an equity investment.

9. The principle factors relevant to determining whether an agreement, that is in legal form a loan, is to be treated as equivalent to a contribution to equity for the purpose of applying the arm's length principle under Division 13 are as set out in paragraph 60 of TR 1992/11. The definition of debt interest and equity interest in Division 974 does not, nor is intended to, supplant these factors.

Appendix 3 – Your comments

10. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date. (Note: the Tax Office prepares a compendium of comments for the consideration of the relevant Rulings Panel or relevant Tax officers. The Tax Office may use a version (names and identifying information removed) of the compendium in providing responses to persons providing comments. Please advise if you do not want your comments included in the latter version of the compendium.)

Due date:	**2 May 2008**
Contact officer:	**Graeme Clark**
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 1992/11

Subject references:

- arm's length
- debt interest
- equity interest
- transfer pricing

Legislative references:

- ITAA 1936 Pt III Div 13
- ITAA 1936 136AA(1)
- ITAA 1936 136AA(3)
- ITAA 1936 136AB(1)
- ITAA 1936 136AC
- ITAA 1997 Div 974
- ITAA 1997 974-10(1)

Other references:

- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001

ATO references

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