

TD 2014/D19 - Income tax: is the reference to 'the interest' as it appears in the phrase at the end of subsection 974 80(2) of the Income Tax Assessment Act 1997 a reference to the interest held by the 'ultimate recipient'?

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This document has been finalised by TD 2015/3.



Draft Taxation Determination

Income tax: is the reference to ‘the interest’ as it appears in the phrase at the end of subsection 974-80(2) of the *Income Tax Assessment Act 1997* a reference to the interest held by the ‘ultimate recipient’?

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This publication is a draft for public comment. It represents the Commissioner’s preliminary view about the way in which a relevant taxation provision applies, or would apply to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

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Ruling

1. Yes. ‘The interest’ referred to in the phrase at the end of subsection 974-80(2)¹ is the interest held by the ‘ultimate recipient’ and not the interest held by the ‘connected entity’.

Date of effect

2. 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 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

12 November 2014

¹ All legislative references are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

Appendix 1 – Explanation

❶ *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 974 contains rules for classifying an interest as debt or equity for certain tax purposes. Section 974-80 is an integrity provision within Division 974. It deals with financing arrangements that grant an investor (the ultimate recipient) an interest which is effectively (in substance but not in form), an equity interest in a company. The provision applies when the equity-like returns that are paid to the ultimate recipient are funded from otherwise tax deductible payments made by the company or connected entities of the company.² That is, where interposed debt interests are used to create ‘de facto’ equity interests, the provision reclassifies the interposed debt interests as equity interests. This causes the returns paid in respect of those same interests to be non-deductible.³

4. Subsection 974-80(1) sets out the situations in which the provision will apply to characterise an interest as an equity interest. Relevantly, there must be an interest which is otherwise not an equity interest held by a connected entity of a company.

5. The interest will be characterised under subsection 974-80(2) provided that one of the requirements in subsection 974-80(2) is satisfied. Subsection 974-80(2) is intended to test whether the interest held by the ultimate recipient should be taken to be effectively an equity interest in the company (or a connected entity of the company).

6. Subsection 974-80(2) ends with the phrase:

and if *the interest* does not form part of a larger interest that is characterised as a *debt interest in the entity in which it is held, or a *connected entity, under Subdivision 974-B.

[Emphasis added]

7. It is not readily apparent on reading subsection 974-80(2) whether ‘the interest’ referred to in the phrase is the interest held by the ultimate recipient or the debt interest held by the connected entity.

8. On a literal reading of subsection 974-80(2), ‘the interest’ referred to may be thought to be the interest held by the connected entity. However, a literal reading is inconsistent with the purpose of the provision and does not consider the phrase in the context of the provision as a whole. When regard is had to the context and purpose of the section, it is clear that ‘the interest’ is a reference to the interest held by the ultimate recipient.

² See paragraphs 2.41 to 2.49 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001. See also paragraphs 1.27 to 1.29 of the Supplementary Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001.

³ Section 26-26 provides that a company cannot deduct:

- a non-share distribution, or a return that has accrued on a non-share equity interest; or
- a dividend paid on an equity interest in the company as a general deduction under the Act.

9. Section 974-80 was not intended to apply if the interest held by the ultimate recipient is a debt interest: see paragraph 2.49 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 where it is stated that:

the debt test... does not apply individually to each of the interests identified in section 974-80 which fund the return to the ultimate recipient. Instead, the test applies in relation to the interest held by the ultimate recipient – if that satisfies the debt test then the funding interests will not be equity interests.

10. The inclusion of the phrase at the end of subsection 974-80(2) was clearly aimed at putting beyond doubt that section 974-80 would not apply where the ultimate recipient holds an equity interest, provided the interest is part of a larger debt interest under subsection 974-15(2).

11. The Commissioner's preferred construction is supported by the last sentence in subsection 974-80(2). It provides that:

The return may be a return of an amount invested in the interest.

12. The 'return' referred to in the last sentence is the return on the interest held by the ultimate recipient as identified throughout subsection 974-80(2). It would be a nonsensical outcome if the two relevant references to 'the interest' in the subsection, appearing as they do with one immediately following the other, were intended to be references to different interests.

13. Accordingly, the Commissioner is of the view that the reference to 'the interest', as it appears in the phrase, is a reference to the interest held by the ultimate recipient.

Appendix 2 – Your comments

14. You are invited to comment on this draft Determination including the proposed date of effect. Please forward your comments to the contact officer by the due date.

15. A compendium of comments is prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments
- be published on the ATO website at www.ato.gov.au.

Please advise if you do not want your comments included in the edited version of the compendium.

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- debt test
- equity test

Legislative references:

- ITAA 1997
- ITAA 1997 26-26
- ITAA 1997 Div 974

- ITAA 1997 Subdiv 974-B

- ITAA 1997 974-15(2)

- ITAA 1997 974-80

- ITAA 1997 974-80(1)

- ITAA 1997 974-80(2)

Other references:

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

ATO references

NO: 1-5XL71OD

ISSN: 1038-8982

ATOlaw topic: Income tax ~- Debt equity rules ~- Application of Division 974

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