


TD 2014/D7 - Income tax: are the capital support payments described in this Draft Determination deductible under section 8-1, section 40-880, subsection 230-15(2) or subsection 230-15(3) of the Income Tax Assessment Act 1997?

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Draft Taxation Determination

Income tax: are the capital support payments described in this Draft Determination deductible under section 8-1, section 40-880, subsection 230-15(2) or subsection 230-15(3) of the *Income Tax Assessment Act 1997*?

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Ruling

1. No. Such payments are capital in nature for the purposes of paragraph 8-1(2)(a) of the *Income Tax Assessment Act 1997*.¹
2. Such payments are not a loss from a financial arrangement and accordingly are not deductible under subsections 230-15(2) or 230-15(3).
3. Such payments are included in the cost base and reduced cost base of the parent's investment in the subsidiary and are therefore not deductible under section 40-880.

Arrangement

4. This Draft Determination applies to an arrangement with all the following features:
 - (a) A parent entity ('parent') agrees to provide its subsidiary with one or more of the following:
 - (i) a lease, license or other right to use one or more assets, not being money or a money equivalent
 - (ii) a legal or equitable interest in one or more such assets, or

¹ Unless otherwise indicated, all legislative references in this Draft Determination are to the *Income Tax Assessment Act 1997*.

- (iii) services.
- (b) The subsidiary agrees to provide consideration to the parent for the things referred to in paragraph (a).
- (c) The parent also agrees to make a payment to the subsidiary which, objectively:
 - (i) is made because all or a part of the subsidiary:
 - (A) has made a loss or losses
 - (B) is not, in the opinion of the parent entity or as agreed between the parent entity and one or more other parties (such as the subsidiary and/or a third party) sufficiently profitable (such as may be the case if the profit of the subsidiary is less than an agreed benchmark), or
 - (C) would or is likely to have made a loss or losses, or not have been sufficiently profitable in the sense used above, were it not for that payment, and
 - (ii) the payment referred to in paragraph (c) does not have the character of:
 - (A) a price for assets or services supplied by the subsidiary to the parent
 - (B) an adjustment to the price of assets or services supplied by the parent to the subsidiary or by the subsidiary to the parent or
 - (C) a loan to the subsidiary or the repayment of such a loan.
- (d) The parent's obligation to provide the things referred to in paragraph (a) is not insignificant compared with the rights and obligations referred to in paragraphs (b) and (c).

5. In determining whether a payment has the character of a price or an adjustment to a price for the purposes of paragraph 4(c)(ii) of this Draft Determination, regard must be had to the terms of the agreement between the parties and the extent of the connection (if any) between the payment and the quantity or quality of the assets or services supplied (if any).

6. For the purposes of paragraph 4(c)(ii)(B) of this Draft Determination, a price adjustment includes a payment which is required in order to ensure that an asset or service is supplied on arm's length conditions or for arm's length consideration. However:

- It must be possible to identify the particular asset or service, or group of assets or services which requires re-pricing.
- A payment cannot have the character of a reduction in the price of something where no price is payable.
- A payment cannot have the character of a reduction in the price of something to the extent that it exceeds that price.

Terminology

7. A payment made as part of an arrangement described in paragraph 4 of this Draft Determination is a **capital support payment** to the extent that it satisfies paragraph 4(c) of this Draft Determination.
8. For the purposes of paragraph 4(c) and 7 of this Draft Determination, the word **payment** refers to any transaction which amounts to payment at law.
9. For the purposes of paragraph 4 of this Draft Determination, the word **service** refers to the doing of work or other beneficial acts for another entity. A subsidiary does not supply a **service** merely by conducting a business on its own account and for its own benefit.
10. For the purposes of paragraph 6 of this Draft Determination:
- **arm's length conditions** has the meaning given by section 815-125; and
 - **arm's length consideration** has the meaning in Division 13 of the *Income Tax Assessment Act 1936* ('ITAA 1936')
11. For the purposes of this Draft Determination a **subsidiary** of an entity (which in this Draft Determination is called a **parent**) is an entity:
- in which the parent holds one or more membership interests², or an economic interest via membership interests in one or more interposed entities; and
 - that would be a 'subsidiary' of that parent entity for the purposes of section 46 of the *Corporations Act 2001* if it is assumed that both entities are bodies corporate for the purposes of that Act.
12. For the purposes of applying this test to an entity other than a body corporate:
- references to control of the composition of the board are taken to be references to the ability to control decision-making in relation to the entity; and
 - references to issued share capital are taken to be references to the membership interests in the entity.
13. An entity is not a **subsidiary** of a **parent** for the purposes of this Draft Determination where both entities are part of the same consolidated group or MEC group.
14. For the purposes of this Draft Determination, an **investment** by a parent entity in a subsidiary includes both a direct investment via membership interests held in the subsidiary as well as an indirect investment held via membership interests in one or more entities interposed between the parent and the subsidiary.

Example 1

15. *Parent Co is a resident company which establishes Sub Co, a wholly-owned subsidiary. Sub Co is established in order to commence a business in a foreign jurisdiction. Parent Co enters into a contract with Sub Co. Under this contract:*

- *Parent Co grants Sub Co a licence to use Parent Co's trademarks and business systems.*

² Refer sections 960-130 and 960-135.

- *Parent Co undertakes to provide Sub Co with a ‘business support service’, whereby it will implement and manage Sub Co’s business strategy.*
- *Sub Co undertakes to pay Parent Co a ‘licence and service fee’ in each financial year in which Sub Co makes a profit.*
- *Parent Co undertakes to make a payment described as a ‘market support payment’ to Sub Co in each financial year in which Sub Co makes a loss, equal to the amount of that loss.*
- *The parties acknowledge that the level of the licence and service fee has been calculated taking into account Parent Co’s commitment to make the market support payment.*
- *The market support payment is expressed to be consideration for Sub Co assuming the risk associated with the use of Parent Co’s trademarks, business systems and business support service in the new market.*

16. *Sub Co makes a loss of \$1 million in its first year of operation. Parent Co pays Sub Co a \$1 million market support payment.*

17. *The payment is a capital support payment. While it may satisfy the positive limb in subsection 8-1(1), it is not deductible because it is of a capital nature for the purposes of paragraph 8-1(2)(a). The payment is objectively made because Sub Co made a loss, and its effect is to preserve the capital value of Parent Co’s investment in Sub Co.*

18. *Viewed objectively, the payment is not the price of an asset or service provided by Sub Co. The assumption of risk by Sub Co is an action taken by Sub Co in the course of conducting its own business, rather than a service provided to Parent Co. Furthermore, the payment could not be a genuine adjustment to the licence and service fee, since no such fee has become payable by Sub Co. The payment is not a price adjustment merely because Parent Co’s potential obligation to make the payment was taken into account in setting the prices of the things supplied by Parent Co.*

19. *The payment is not deductible under Division 230 because the arrangement is not a financial arrangement. The payment is not deductible under section 40-880 but is included in the cost bases and reduced cost bases of Parent Co’s shares in Sub Co.*

Example 2

20. *Adopting the same facts as in Example 1, assume further that:*

- *Sub Co has been operating profitably for a number of years, then*
- *due to difficult trading conditions in its market, Sub Co makes losses throughout the year, and*
- *Parent Co makes a series of payments through the year to Sub Co totalling \$1 million under the terms of the contract.*

21. *The reasoning in Example 1 also applies in this example. The payments are capital support payments. They are not deductible under section 8-1 as they are losses or outgoings of a capital nature. Viewed objectively, the payments are made because Sub Co made losses, and their effect is to preserve the capital value of Parent Co’s investment in Sub Co, notwithstanding that the payments are made several years after those shares were acquired. The payments are not deductible under Division 230 because the contract is not a financial arrangement. The payments are not deductible under section 40-880 but are included in the cost bases and reduced cost bases of the shares in Sub Co.*

Example 3

22. *Parent Co, a resident company, is a manufacturer, distributor and retailer of products. It establishes a subsidiary, Sub Co, in a foreign jurisdiction to distribute and retail its products utilising marketing concepts and strategies developed by Parent Co.*

23. *Under a Service and Licence Agreement:*

- *Parent Co grants to Sub Co the exclusive right to use Parent Co's trademarks, marketing strategies and know-how in the jurisdiction, for which Sub Co will pay a licence fee in each year Sub Co achieves an agreed profit.*
- *Parent Co also agrees to pay a 'Service fee' to Sub Co. The 'Service Fee' is for the provision of services such as relationship management with local distributors, brand promotion and management of local stores.*
- *The 'Service Fee' comprises two amounts:*
 - *Amount A – which is equal to so much of Sub Co's expenditure on advertising and promotion as exceeds the amount an independent distributor would have incurred in comparable circumstances; and*
 - *Amount B – which is such an amount as is necessary to ensure Sub Co achieves a specified level of profit.*

24. *Sub Co has incurred significant losses due to adverse trading conditions and the expenditure incurred on the marketing strategies it adopted following Parent Co's strategy. Parent Co pays Sub Co a 'Service Fee' comprising both Amount A and Amount B.*

25. *Amount A is not a capital support payment and is deductible under section 8-1. Objectively, it is not paid merely because Sub Co has made a loss or was not sufficiently profitable.*

26. *Amount B is a capital support payment. It is only paid because Sub Co made a loss. The payment bears no necessary connection to the quality or quantity of services provided by Sub Co to Parent Co.*

27. *While Amount B may satisfy the positive limb in subsection 8-1(1), it is not deductible because it is of a capital nature for the purposes of paragraph 8-1(2)(a). Amount B is objectively paid because Sub Co made a loss, and its effect is to preserve the capital value of Parent Co's investment in Sub Co.*

28. *Amount B is not deductible under Division 230 because the arrangement is not a financial arrangement. It is not deductible under section 40-880 but is included in the cost bases and reduced cost bases of Parent Co's shares in Sub Co.*

Example 4

29. *Head Co is a resident company which establishes Distributor Co, a wholly-owned subsidiary. Distributor Co is established in order to commence a business in a foreign jurisdiction. Head Co and Distributor Co have entered into an agreement. Under the agreement:*

- *Distributor Co will be the sole distributor in its market for goods manufactured by Head Co.*

- *Distributor Co will purchase goods from Head Co and distribute and market them in its market.*
- *The terms of the agreement indicate that Distributor Co is a limited risk distributor.*
- *Head Co grants Distributor Co a licence to use Head Co's trademarks and other intellectual property for the purposes of distributing Head Co's goods.*
- *In return, Distributor Co undertakes to support and promote Head Co's trademarks and products in the foreign jurisdiction.*
- *The price for the goods imported by Distributor Co from Head Co and the sale price of the goods to purchasers is based on certain assumptions which are designed to allow Distributor Co to achieve an arm's length return.*
- *The transactional net margin method ('TNMM')³ has been identified as the most appropriate methodology to test transfer prices for the arrangement in place.*
- *Based on a comparability analysis the parties agree that an adjustment will be made at year end such that Distributor Co will achieve an agreed EBIT/Sales ratio for the goods imported and distributed by Distributor Co.*

30. *During the first year, Distributor Co does not earn the margin it expected on the sale of goods acquired from Head Co and a \$1m loss has been recorded by Distributor Co. It is determined that a \$1.5m adjustment is required to the prices of goods purchased by Distributor Co to achieve the required EBIT/Sales ratio. A payment of \$1.5m is made by Head Co to Distributor Co.*

31. *This payment is deductible under section 8-1. It is not a capital support payment for the purposes of this Draft Determination. Objectively the payment is made as an adjustment to the prices of the goods supplied by Head Co to Distributor Co.*

Example 5

32. *Continuing on from Example 4. Head Co and Distributor Co agree to implement a market penetration strategy⁴ in order to lift their share of the market. Under the agreement:*

- *Distributor Co will undertake sales and marketing activities in excess of what an independent low risk distributor would undertake.*
- *Head Co will own all marketing intangibles that may arise from the additional sales and marketing activities.*
- *Sales of goods manufactured by Head Co may be made at reduced prices.*
- *In recognition of Distributor Co being a limited risk distributor, the financial impact of the increased sales and marketing activities and the reduced sales price of the goods will be borne by Head Co.*

³ See Taxation Ruling TR 97/20, paragraphs 3.73-3.87.

⁴ Refer Taxation Ruling TR 97/20, paragraphs 2.47-2.56.

- *It is recognised that Distributor Co as a limited risk distributor is entitled to a return for the services it is providing in respect of the market penetration strategy as well as for its business as usual. As a result of a comparability analysis an operating profit of 10% of the operating expenses of Distributor Co is determined to be the arm's length profit appropriate for the circumstances.*

33. *In the first year of the market penetration strategy Distributor Co makes an operating loss of \$1m with operating expenses of \$5m. A payment of \$1.5m is made by Head Co to Distributor Co, representing the financial impact on Distributor Co of increased sales and marketing expenses as well as reductions in the sale prices of goods sold by Distributor Co. As a result of this payment Distributor Co makes an operating profit of \$0.5m for the financial year.*

34. This payment is not a capital support payment. Objectively the payment represents an adjustment to the price of the goods supplied by Head Co to Distributor Co together with the price of the services provided by Distributor Co to Head Co. The payment is deductible under section 8-1.

Example 6

35. *Main Co is a resident company which has developed intellectual property, business systems and know how (collectively referred to as 'intangibles') which are used in the provision of services to third parties. It establishes Service Co, a wholly-owned subsidiary, in order to commence the business of providing those services in a foreign jurisdiction. Main Co and Service Co enter into an agreement under which:*

- *Main Co grants Service Co an exclusive right to use the intangibles in its market for the purpose of providing services to third parties in that market.*
- *Main Co also undertakes to provide such services to Service Co as are required for Service Co to operate effectively in the foreign jurisdiction.*
- *The terms of the agreement indicate that Service Co is a limited risk provider of the services to third parties in its market, with Main Co assuming the balance of the risk (that is, the risk associated with use of the intangibles). As a limited risk service provider Service Co agrees to represent Main Co in its market and to provide all services required to enable the business of Main Co to be carried out in its market.*
- *TNMM has been identified as the most appropriate methodology to test the transfer prices for the total arrangement in place (which includes the intangibles and services provided by Main Co and the services provided by Service Co) and an appropriate profit level indicator has been selected.*
- *Based on a comparability analysis the parties agree that adjustments will be made quarterly such that Service Co will achieve an operating profit margin in relation to its services which is consistent with an arm's length arrangement.*

36. *For the first year of the agreement operating profit margins achieved by Service Co have been lower than expected and it makes a loss. Adjustments totalling \$1.5m are made to enable Service Co to achieve the required profit outcome as determined under the TNMM.*

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37. *These payments are not capital support payments. Objectively, the payments are made as adjustments to the prices of the services and intangibles supplied under the arrangement. These payments are deductible under section 8-1.*

Date of effect

38. 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

29 January 2014

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.*

Background

Capital support payments

39. The term **capital support payment** is defined in paragraph 4(c) of this Draft Determination (see paragraph 7). Where a payment does not wholly satisfy paragraph 4(c), it is a capital support payment to the extent that it does satisfy that paragraph (see paragraphs 81-82).

40. In determining whether a payment by a parent to a subsidiary is a capital support payment it is necessary to consider whether the payment is, objectively, made merely because of the losses or insufficient profits of the subsidiary.

41. Such payments may be designed to provide financial assistance to a subsidiary in a start-up period or in times of adverse business conditions or financial stress. Financial support may be required where a subsidiary experiences difficulties entering a new market, as a result of market downturns or for other reasons.

42. In determining whether a payment has the character of a capital support payment, it is necessary to have regard to both the form and substance of the arrangement between the parties. In this regard, it may be necessary to consider whether independent parties dealing wholly independently of one another would have made such payments in comparable circumstances.

Payment

43. For the purposes of paragraphs 4(c) and 7 of this Draft Determination, the word ‘payment’ refers to any transaction which amounts to payment at law. This includes a legally effective set-off of mutually owing obligations.⁵ It does not include a mere book entry which has no effect on the legal rights or obligations of the parties.⁶

Not a price for assets or services

44. By definition, a capital support payment is to be distinguished from a payment which has the character of a price for an asset or service. Payments in the latter category do not arise as a result of losses or profits but are earned by, or are a ‘quid pro quo’ for, the supply of the assets or services in question.⁷ They are a function of, and reflect, the quality and quantity of the things supplied.

45. In contrast, capital support payments have the objective purpose and effect of enabling the parent to underwrite the activities of the subsidiary, and, in so doing, to protect the value of their investment and to secure it as a future source of income.

⁵ *In re Harmony and Montague Tin and Copper Mining Co Ltd* (‘Spargo’) (1873) LR 8 Ch App 407.

⁶ See, for example *FC of T v. P. Iori & Sons Pty Ltd* 87 ATC 4775; *Lend Lease Corp Ltd v. FC of T* 90 ATC 4401; *Temples Wholesale Flower Pty Ltd v. FC of T* 91 ATC 4387.

⁷ *Australian Woollen Mills Pty Ltd v. Commonwealth* (1954) 92 CLR 424.

46. Capital support payments may be described as a means of reflecting the risk a subsidiary is exposed to where it is compelled, requested or otherwise decides to operate, or operate in a particular way, in a new or existing market. The subsidiary may be exposed to risk as a result of its use of the intellectual property, systems, business strategies and know-how of its parent. However, it does not follow that such payments represent the price of a 'service' by the subsidiary.

47. In this Draft Determination the word 'service' is used to refer to the doing of work⁸ or other beneficial acts for another entity. For these purposes, the doing of an act for someone is to be contrasted with the doing of an act which has the incidental effect of benefiting someone.

48. Accordingly, the mere conduct of a business by a subsidiary on its own account and for its own benefit does not constitute the provision of a service.⁹ While the conduct of the subsidiary's business and its exposure to risk may provide advantages to the parent, those advantages accrue through the parent's investment in the subsidiary rather than through the enjoyment of a service.

49. In contrast, a subsidiary may perform a service for its parent by engaging in activities for the benefit of its parent which it would not otherwise be expected to undertake. It might, for instance, undertake additional marketing or advertising activities, or implement a genuine market penetration strategy¹⁰ for the benefit of its parent.

50. A payment cannot be characterised as the price of an asset or service where the occasion for it is found in the parent's pre-existing obligation to make good an entity's losses or insufficient profits. Such a payment reflects the overall economic performance of the subsidiary rather than the character of what (if anything) is being supplied to the parent.

51. In determining whether a payment has the character of a price for an asset or service, it is relevant to consider how the payment is calculated. It may be inferred that a payment does not have the character of a price where:

- it is calculated as an amount which is equal to (or equal to a portion of) a loss or shortfall in profit; and
- that loss or profit shortfall reflects factors other than the quality or quantity of the assets or services supplied

52. In characterising a payment it is necessary to have regard to the terms of the agreement between the parties. However, the labels used by the parties are not determinative of the character of the payment.¹¹ The parties cannot, by mere labelling or description, make a payment into the price of an asset or service when it does not truly have that character.¹² The effect of the arrangement must be determined by a proper reading of the contract taken as a whole, rather than by reference to particular labels or descriptions adopted by the parties.

⁸ See *Employers Mutual Indemnity Association Ltd v. Federal Commissioner of Taxation* [1943] HCA 36; (1943) 68 CLR 165.

⁹ *FC of T v. Cooke & Sherden* 80 ATC 4140 at 4151.

¹⁰ Refer Taxation Ruling TR 97/20, paragraphs 2.47-2.56.

¹¹ See, for example, *John Fairfax & Sons Pty Ltd v. Federal Commissioner of Taxation* (1959) 101 CLR 30 at 46; (1959) 11 ATD 510 at 512; *Cliffs International Inc v. Federal Commissioner of Taxation* 79 ATC 4059 at 4064; *Case N8 81* ATC 50 at 55-56; *Australia and New Zealand Savings Bank Limited v. FC of T* 93 ATC 4370 at 4390; (1993) 25 ATR 369 at 392.

¹² *South Sydney District Rugby League Football Club Ltd v. News Ltd* [2000] FCA 1541 at [135]; *Re Porter*; *Re Transport Workers Union of Australia* (1989) 34 IR 179 at 184; *Federal Commissioner of Taxation v. Broken Hill Pty Co Ltd* [2000] FCA 1431 at [50]; *Noza Holdings Pty Ltd v. FCT* [2011] FCA 46 at [238].

Not a price adjustment

53. A distinction is also to be drawn between a capital support payment and a payment which has the character of an adjustment to the price of an asset or service supplied to the subsidiary or parent.

54. In determining whether a payment has the character of an adjustment to a price, it is necessary to have regard to the terms of the agreement between the parties. Again, however, the parties cannot, by mere labelling or description, make a payment into a price adjustment when it does not truly have that character; see paragraph 52 of this Draft Determination.

55. In characterising a payment it is necessary to consider the extent of the connection, if any, between the payment and the quantity or quality of the assets or services being supplied. A payment cannot be characterised as an adjustment to the price of assets or services unless it is possible to identify how the payment affects their pricing. In determining whether a payment represents a price adjustment it is relevant to consider how the payment is calculated; see paragraph 51 of this Draft Determination.

56. Payments which have the character of an adjustment to the price of an asset or service include payments which are required in order to achieve arm's length conditions between parent and subsidiary for the purposes of Division 815 or arm's length consideration for the purposes of Division 13 of the ITAA 1936. Such payments are made in order to ensure that the prices which are payable for assets and services reflect the conditions which might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.¹³

57. For example, an Australian parent with an overseas subsidiary may have a documented transfer pricing agreement under which a profit-based method is used to test the pricing of goods and services they exchange. This agreement may outline the methodologies to be employed in order to set or review those prices, and provide for 'true up' payments to be made at pre-determined periods in response to those regular reviews. Subject to a full analysis of the arrangement, having regard to the requirements of Division 815, payments by the parent to the subsidiary in these circumstances are not capital support payments for the purposes of this Draft Determination.

58. Conversely, it may be inferred that a payment is not a price adjustment where it is not one which would be made if it were assumed that the parent and subsidiary were independent parties dealing wholly independently with one another in comparable circumstances. In such cases the character of the payment may be derived from the investment relationship between the parties rather than the character of what (if anything) is being exchanged between them.

59. A payment cannot be characterised as a price adjustment unless it is possible to identify assets or services which have a price and which are being re-priced. Further, a payment could not be a genuine reduction to a price where no price is payable or where the payment purports to reduce the price by an amount that exceeds the amount of that price.

¹³ See section 815-125.

Parent-subsidiary relationship

60. For the purposes of this Draft Determination, capital support payments are limited to payments made by a parent entity to its subsidiary.

61. This Draft Determination identifies parent-subsidiary relationships by reference to the concept of 'membership interest' in sections 960-130 and 960-135 as well as the *Corporations Act 2001*.

62. Section 46 of the *Corporations Act 2001* provides :

A body corporate (in this section called the first body) is a subsidiary of another body corporate if, and only if:

- (a) the other body:
 - (i) controls the composition of the first body's board; or
 - (ii) is in a position to cast, or control the casting of, more than one-half of the maximum number of votes that might be cast at a general meeting of the first body; or
 - (iii) holds more than one-half of the issued share capital of the first body (excluding any part of that issued share capital that carries no right to participate beyond a specified amount in a distribution of either profits or capital); or
- (b) the first body is a subsidiary of a subsidiary of the other body.

63. For the purposes of applying this test to an entity other than a body corporate, it is to be assumed that the entity is a body corporate. For this purpose, references to control of the board are taken to be references to the ability to control decision-making in relation to the entity. References to share capital are taken to be references to interests which would be membership interests in the entity for the purposes of sections 960-130 and 960-135.

Deductibility under section 8-1

64. Section 8-1 relevantly provides:

8-1(1)

You can deduct from your assessable income any loss or outgoing to the extent that:

- (a) it is incurred in gaining or producing your assessable income; or
- (b) it is necessarily incurred in carrying on a *business for the purpose of gaining or producing your assessable income.

8-1(2)

However, you cannot deduct a loss or outgoing under this section to the extent that:

- (a) it is a loss or outgoing of capital, or of a capital nature;

General principles

65. In *Sun Newspapers Ltd and Associated Newspapers Ltd v. Federal Commissioner of Taxation*¹⁴ (*Sun Newspapers*), the taxpayer was denied a deduction for an amount paid to prevent a rival publisher from producing a newspaper in the area for a period of three years. The expenditure was held to be capital in nature. In coming to his decision Dixon J made a distinction between capital expenditure, being the amount used for establishing, replacing and enlarging the business entity, structure or the profit yielding subject, and revenue expenditure being the working expenses incurred in carrying on a business.

66. Dixon J stated in *Sun Newspapers* that:

The distinction between expenditure and outgoing on revenue account and on capital account corresponds with the distinction between the business entity, structure, or organisation set up or established for the earning of profit and the process by which such an organisation operates to obtain regular returns by means of regular outlays. The difference between the outlay and returns representing profit or loss.¹⁵

67. Dixon J outlined a number of factors which may assist in making the revenue/capital distinction:

There are, I think, three matters to be considered, (a) the character of the advantage sought, and in this its lasting qualities may play a part, (b) the manner in which it is to be used, relied upon or enjoyed, and in this and under the former head recurrence may play its part, and (c) the means adopted to obtain it; that is, by providing a periodical reward or outlay to cover its use or enjoyment for periods commensurate with the payment or by making a final provision or payment so as to secure future use or enjoyment.¹⁶

68. The character of the advantage sought will generally provide the most useful guidance in determining the character of a loss or outgoing: *Federal Commissioner of Taxation v. Email Ltd*¹⁷ (*Email*).

69. Where a payment is made in order to discharge a pre-existing obligation, the advantage sought is characterised by reference to the obligation rather than the payment. In *Email* the Full Federal Court considered the character of payments made pursuant to an indemnity which was connected to the sale of shares in a related company. The Court noted:¹⁸

... it is common ground that it is the character of the advantage which the indemnity was calculated to effect, not directly the character of the payments themselves which must fall for consideration.

Characterisation of capital support payments

70. The advantage sought by a capital support payment is to preserve or increase the capital value of a parent's investment in a subsidiary.

71. A capital support payment is, or has substantially the effect of, a non-scrip capital contribution to the subsidiary.¹⁹ It preserves or increases the value of the parent's investment in the subsidiary, even though the subsidiary does not issue additional membership interests.

¹⁴ (1938) 61 CLR 337; (1938) 5 ATD 87; (1938) 1 AITR 403.

¹⁵ At CLR 359; ATD 93-94; AITR 410.

¹⁶ At CLR 363; ATD 96; AITR 413.

¹⁷ [1999] FCA 1177; 99 ATC 4868; (1999) 42 ATR 698.

¹⁸ *Email* at 704.

¹⁹ See, for example, *National Mutual Life Association of Australia v. Federal Commissioner of Taxation* [2009] FCAFC 96, 2009 ATC 20-124.

72. The character of this advantage is structural and enduring. Capital support payments are used to establish or maintain the business entity, structure or organisation through which profits are generated. They are made for the benefit of the income producing unit within which production is carried on, rather than for the production of the income itself.

73. The character of the advantage obtained by a capital support payment arrangement reflects the terms upon which such payments are required. A capital support payment is required when a subsidiary suffers losses or makes insufficient profits; rather than when, for instance, the subsidiary supplies an asset or service to its parent. Payments that are calculated with reference to the losses or profits of a subsidiary are objectively to be regarded as having the purpose of maintaining the subsidiary's capital structure. In terms of Dixon J's analysis in *Sun Newspapers*, such payments cannot therefore be regarded as part of the process by which such an organisation operates to obtain regular returns by means of regular outlays.

74. For the reasons explained in paragraph 52 of this Draft Determination, a payment which is calculated by reference to the losses or profits of another entity cannot be considered an outgoing on revenue account merely by reference to the description of the payment in a contract. Furthermore, the distinction between revenue and capital expenditure depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights.²⁰ From a practical and business point of view, the purpose and effect of a capital support payment from the parent entity's perspective is to preserve or increase the capital value of its investment in a subsidiary.

75. *Bell & Moir Corporation Pty Ltd v. Federal Commissioner of Taxation*²¹ (*Bell & Moir*) illustrates that the character of the advantage sought by payments – what they were calculated to effect from a practical and business point of view – is to be determined from the payer's perspective. There Hely J considered a situation where a shareholder in a company provided a guarantee to a bank on an overdraft for the company. The taxpayer was required to make a payment to the bank under the guarantee agreement. The payment under the guarantee was the subject of the claim for deduction. Hely J found the payment of the guarantee to be capital in nature because:

It is the character of the advantage sought by the taxpayer for itself by making the outgoing for which deduction is sought which is the chief factor in determining whether the outgoing is on revenue or capital account.²²

76. Hely J went on to say:

The nature of the benefit or advantage sought was the propping up of BMM so that the applicant could continue to trade with it. That is the type of enduring benefit which will ordinarily result in the cost of acquiring it as being characterised as capital in nature.²³

77. Hely J further observed that:

²⁰ *Hallstroms Pty Ltd v. Federal Commissioner of Taxation* (1946) 72 CLR 634 per Dixon J at 648; (1946) 8 ATD 190 at 196.

²¹ [1999] FCA 1009; 99 ATC 4738; (1999) 42 ATR 421.

²² *Bell & Moir* at 14.

²³ *Bell & Moir* at 20.

...insofar as the guarantee is undertaken to secure a source of income the payments required to be made under the guarantee are associated with the acquisition of a position from which to earn income rather than with the day to day revenue costs of deriving income.²⁴

78. Similarly, the objective purpose of a capital support payment arrangement is to secure the subsidiary as a source of future income, whether in the form of fees, royalties, dividends or other amounts. Such payments relate to the creation or maintenance of a profit yielding asset as opposed to the process of operating it, and accordingly those payments have the character of capital from the parent entity's perspective.

79. This is the case, whether or not the obligation to make the support payment is directly connected to the parent's right to receive the consideration referred to in paragraph 4(b) of this Draft Determination. In either case, the payment is, in substance, a capital outgoing designed to secure the subsidiary as a potential source of income in future years.²⁵ However, a capital support payment does not include a payment which has the character of a price for assets or services provided by the subsidiary to the parent, or an adjustment to such a price.²⁶

80. Although capital support payments may secure a future source of income, their character differs fundamentally from the payments made to secure exclusive trading rights considered in *BP Australia Ltd v. Federal Commissioner of Taxation*²⁷ and *National Australia Bank Ltd v. Federal Commissioner of Taxation*.²⁸ The payments considered in those cases were not calculated by reference to the losses or profits of, or to otherwise 'prop up', a subsidiary entity.

Apportionment

81. A payment is only considered to be a capital support payment to the extent that it satisfies paragraph 4(c) of this Draft Determination. Conversely, a payment may be of a revenue nature to the extent that it does not satisfy paragraph 4(c) of this Draft Determination. Whether this is the case depends on the character of the payment.

82. Where a payment is partly of a capital nature and partly of a revenue nature, it is necessary to perform an apportionment in order to determine the extent to which it is deductible under subsection 8-1(1).²⁹ For this purpose, the Commissioner will accept any method which provides a fair and reasonable reflection of the extent to which the objective purpose or effect of the payment is to preserve or increase the capital value of the parent's investment in the subsidiary.

²⁴ *Bell & Moir* at 33.

²⁵ See, for example *Case 49/95* 95 ATC 422 at 425.

²⁶ Refer paragraph 4(c)(ii) of this Draft Determination.
²⁷ (1965) 112 CLR 386; 9 AITR 615; 14 ATD 1.

²⁸ 97 ATC 5153; (1997) 37 ATR 378.

²⁹ *Ronpibon Tin N.L. and Tongkah Compound N.L. v. Federal Commissioner of Taxation* (1949) 78 CLR 47 at 55; *Poole and Dight v. Federal Commissioner of Taxation* (1970) 122 CLR 427, at 440; 70 ATC 4047 at 4054; *Europa Oil (N.Z.) Ltd. v. Commr. of I.R. (N.Z.)* 76 ATC 6001, at p. 6006; (1976) 1 WLR 464, at 472-473; *FC of T v. South Australian Battery Makers Pty Ltd* 78 ATC 4412 at 4416.

Deductibility under section 230-15

83. Subsection 230-15(2) provides deduction for a loss an entity makes from a financial arrangement, to the extent that the loss is made in gaining or producing its assessable income or is necessarily incurred in carrying on a business for the purposes of gaining or producing such income.

84. Subsection 230-15(3) provides a deduction for certain losses from a financial arrangement which are made in deriving certain income from a foreign source.

85. Neither subsections 230-15(2) or 230-15(3) apply to a capital support payment, since such a payment is not a loss from a 'financial arrangement'.

86. Subsection 230-45(1) provides:

You have a **financial arrangement** if you have, under an *arrangement:

- (a) a *cash settlable legal or equitable right to receive a *financial benefit; or
- (b) a cash settlable legal or equitable obligation to provide a financial benefit; or
- (c) a combination of one or more such rights and/or one or more such obligations;

unless:

- (d) you also have under the arrangement one or more legal or equitable rights to receive something and/or one or more legal or equitable obligations to provide something; and
- (e) for one or more of the rights and/or obligations covered by paragraph (d):
 - (i) the thing that you have the right to receive, or the obligation to provide, is not a financial benefit; or
 - (ii) the right or obligation is not cash settlable; and
- (f) the one or more rights and/or obligations covered by paragraph (e) are not insignificant in comparison with the right, obligation or combination covered by paragraph (a), (b) or (c).

The right, obligation or combination covered by paragraph (a), (b) or (c) constitutes the financial arrangement.

87. Under the arrangement described in paragraph 4 of this Draft Determination the parent has an obligation to provide things which are not cash settlable and that obligation is significant. Accordingly, the parent's obligation to make payments and right to receive consideration is not, and is not part of, a 'financial arrangement' for the purposes of section 230-45.³⁰

³⁰ A financial arrangement may exist in circumstances where the parent does not have a significant non-cash settlable obligation. A loss under such an arrangement is deductible to the extent that it otherwise satisfies the requirements in section 230-15. However, in a cross-border context it would be necessary to consider whether the arrangement gives rise to a transfer pricing benefit for the purposes of section 815-120 or involves consideration other than arm's length consideration for the purposes of Division 13 of the ITAA 1936.

Deductibility under section 40-880

88. Subsection 40-880(2) provides deduction, in equal proportions over 5 income years, for capital expenditure an entity incurs:

- in relation to its business
- in relation to a business that used to be carried on
- in relation to a business proposed to be carried on
- to liquidate, deregister or wind up certain entities.

89. However, an amount cannot be deducted under subsection 40-880(2) to the extent that the expenditure could be taken into account in working out the amount of a capital gain or capital loss from a CGT event (paragraph 40-880(5)(f)).

90. The cost base and reduced cost base of a CGT asset have five elements and are defined in sections 110-25 and 110-55 respectively.

91. The fourth element of cost base and reduced cost base comprises capital expenditure incurred for the purpose or the expected effect of increasing or preserving the value of the CGT asset (subsections 110-25(5) and 110-55(2)). The objective purpose and effect of a capital support payment is to increase or preserve the value of a parent's investment in a subsidiary. A capital support payment is therefore considered to be included in the fourth element of the cost base and reduced cost base of a parent's direct or indirect investment in the subsidiary.

92. To the extent that the parent holds its investment directly by owning membership interests in the subsidiary, the payment is included in the cost base and reduced cost base of those interests. To the extent that the parent holds its investment indirectly through interposed entities, the payment is included in the cost bases and reduced cost bases of the parent's interests in those entities.

Appendix 3 – Your comments

93. 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.

94. 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; and
- 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.

Due date: 28 February 2014
Contact officer: Natasha Zorzi
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Previous Draft:

TD 2013/D3

Related Rulings/Determinations:

TR 97/20; TR 2006/10

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