TD 2018/D6 - Income tax: can the debt and equity rules in Division 974 of the Income Tax Assessment Act 1997 limit the operation of the transfer pricing rules in Subdivision 815-B of the Income Tax Assessment Act 1997 ?

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This document has been finalised by TR 2019/10.

There is a Compendium for this document: **TD 2019/10EC** .

Draft Taxation Determination

Income tax: can the debt and equity rules in Division 974 of the *Income Tax Assessment Act 1997* limit the operation of the transfer pricing rules in Subdivision 815-B of the *Income Tax Assessment Act 1997*?

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Ruling

1. No. Subsection 815-110(1) of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] states expressly that nothing in the income tax assessment legislation[2] (other than Subdivision 815-B) limits the operation of Subdivision 815-B.

2. Where section 815-115 applies in respect of a scheme that is a financing arrangement[3], the 'arm's length conditions' within the meaning of section 815-125 are taken to operate for the purposes set out in subsection 815-115(2) – that is, working out the amount of the entity's taxable income, taxable loss of a particular sort, tax offsets and withholding tax payable.

3. In such instances, Division 974 applies to classify the interest that arises under the scheme by reference to the arm's length conditions, not to the actual conditions.

Examples

4. The following examples illustrate the effect of the transfer pricing rules on the debt equity rules. The examples assume what the arm's length conditions are in the relevant circumstances for the purpose of illustrating the effect. They should not be taken as ruling on what the arm's length conditions would be.

[1] All legislative references are to the ITAA 1997, unless otherwise indicated.
[2] That is, the ITAA 1997 and the *Income Tax Assessment Act 1936* (ITAA 1936).
[3] As defined in section 974-130.

Example 1 – outbound loan to a distressed subsidiary

5. *Australian Company, an Australian resident company, lends $15 million to Foreign Company, a wholly-owned foreign resident subsidiary, to fund the completion of a new manufacturing plant. Due to difficult economic conditions, Foreign Company is only just managing to meet all its financial obligations.*

6. *A term of the loan agreement is that interest will not begin to accrue on the loan principal until the start of the accounting period following that in which the Australian Company first has an accounting profit. The term of the loan is more than 10 years. The interest rate is 9% per annum.*

7. *Without the application of Subdivision 815-B, the loan would not satisfy the debt test. Foreign Company does not have an effectively non-contingent obligation to provide financial benefits with a present value at least equal to the value of the financial benefits they received.*[4]

8. *Rather, the loan would satisfy the equity test because Foreign Company's right to receive interest on the loan is contingent on the economic performance of the issuer.*[5] *As a result, any interest Australian Company receives from Foreign Company would be non-assessable non-exempt income.*

9. *However, had arm's length conditions operated instead of the actual conditions, the loan would give rise to a debt interest. Under Subdivision 815-B, there would be a loan with interest that would have accrued from commencement of the loan term at a rate of 9%.*

10. *Subdivision 768-A would not apply and any interest Australian Company received would be included in its assessable income.*[6] *Australian Company therefore gets a transfer pricing benefit under subsection 815-120(1). Subsection 815-115(1) would operate to substitute the arm's length conditions for the actual conditions for the purposes of subsection 815-115(2).*

Example 2 – inbound discretionary interest loan

11. *Foreign Company, a non-resident company, makes a loan to Australian Company, a wholly-owned Australian subsidiary, for a term of 15 years. There is no obligation to pay interest on the loan but Australian Company can, at its sole discretion, pay interest at the end of each year accruing at a rate of 10% per annum to Foreign Company. The interest is non-cumulative.*

12. *Without the application of Subdivision 815-B, the loan would not satisfy the debt test. Australian Company does not have an effectively non-contingent obligation to provide financial benefits at least equal to the value of the financial benefits received on a present value basis.*[7]

13. *Rather, the loan would satisfy the equity test because it carries a right to a return from, and at the discretion of, Australian Company.*[8] *Any interest paid to Foreign Company would constitute a non-share dividend and may be subject to dividend withholding tax.*[9]

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[4] Section 974-20 and subparagraph 974-35(1)(a)(ii).
[5] Section 974-75(1) table item 2.
[6] Section 768-5.
[7] Sections 974-20 and 974-35.
[8] Subsection 974-75(1) table item 3.
[9] Section 974-120, section 128AAA and subsection 128B(1) of the ITAA 1936.

14. *Had the arm's length conditions operated instead of the actual conditions, the loan would give rise to a debt interest. Under Subdivision 815-B, there would be a loan with interest on the outstanding principal accruing periodically and an obligation to pay all outstanding accrued interest at the end of the loan term.*

15. *Under the actual conditions, there would be no interest withholding tax payable. It follows that the amount of interest withholding tax payable would be greater under the arm's length conditions. Australian Company therefore gets a transfer pricing benefit equal to the full amount of the interest withholding tax that would be payable had the arm's length conditions operated.*[10] *Section 815-115 would operate to substitute the arm's length conditions for the actual conditions.*

16. *To the extent Australian Company would have received an allowable deduction for interest it is taken to have paid under arm's length conditions, the Commissioner may make a determination to adjust Australian Company's taxable income or loss, provided the relevant conditions are satisfied.*[11]

Example 3 – outbound interest-free loan

17. *Australian Company makes a loan to Foreign Company, a wholly-owned foreign company. Foreign Company is in the exploration stage of a mining business and could not obtain debt financing from an unrelated party.*

18. *The loan is for a nine-year term and is interest-free. Without the application of Subdivision 815-B it satisfies the debt test.*

19. *Having regard to section 815-130, the arm's length conditions are identified on the basis of commercial or financial relations that involve a contribution of equity rather than a loan. These arm's length conditions would satisfy the equity test because they do not involve an effectively non-contingent obligation to provide financial benefits at least equal to the value of the financial benefits received on a present value basis.*

20. *However, as there is no transfer pricing benefit under the arm's length conditions, Subdivision 815-B does not operate and the classification of the arrangement as a debt interest is not affected.*

Date of effect

21. When the final Determination is issued, it is proposed to apply to income years commencing on or after 29 June 2013. This corresponds with the commencement of Subdivision 815-B.

22. Subdivision 815-B applies to transactions or arrangements that occurred before 29 June 2013, to the extent that those transactions or arrangements affect an entity's Australian tax position in the income years to which Subdivision 815-B applies.

[10] Subsection 815-120(1).
[11] Section 815-145.

23. The Determination will not apply to taxpayers to the extent it conflicts with the terms of settlement of a dispute agreed to before this Determination's date of issue (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10 *Public Rulings*).

Commissioner of Taxation
31 October 2018

Appendix 1 – Background

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.

Transfer pricing rules in Subdivision 815-B

24. The object of Subdivision 815-B is to ensure an entity's tax position in relation to its cross-border dealings is determined on the basis of conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances (the 'arm's length principle').[12]

25. Broadly, Subdivision 815-B may apply to an entity's cross-border dealings where:

- the 'actual conditions' that operate between the entity and another entity in connection with their commercial or financial relations differ from the 'arm's length conditions'[13], and
- that difference results in a 'transfer pricing benefit' for the entity.[14]

26. An entity gets a 'transfer pricing benefit' where its:

- taxable income would be greater
- loss would be less
- tax offsets would be less, or
- withholding tax payable on interest or royalties would be greater.

27. Where an entity gets a transfer pricing benefit from actual conditions that differ from the arm's length conditions, the arm's length conditions are substituted for the actual conditions for the purposes of working out the amount of the entity's taxable income, taxable loss of a particular sort, tax offsets and withholding tax payable.[15]

Debt and equity rules in Division 974

28. The tests in Division 974 determine whether a scheme that is a financing arrangement gives rise to a debt interest or an equity interest. This is relevant to:

- determining whether a payment relating to an interest may be deductible or frankable
- the dividend and interest withholding tax rules, and
- the thin capitalisation rules.[16]

[12] Sections 815-105 and 815-125.
[13] Refer to Taxation Ruling TR 2014/6 *Income tax: transfer pricing – the application of section 815-130 of the Income Tax Assessment Act 1997* for guidance on identifying the 'actual conditions' and the 'arm's length conditions'.
[14] Section 815-120.
[15] Section 815-115.
[16] Subsection 974-10(1).

Interaction between Division 974 and Subdivision 815-B

29. Subdivision 815-B applies to any cross-border dealing where an entity would get a tax advantage from the actual conditions of that dealing, that they would not get had arm's length conditions operated instead. In these cases, the arm's length conditions are taken to operate for income tax and withholding tax purposes.[17]

30. Subdivision 815-B negates a transfer pricing benefit that an entity gets if a scheme that is a financing arrangement is an equity interest (or a debt interest) under actual conditions, but would give rise to a debt interest (or an equity interest) had arm's length conditions operated.

31. Subsection 815-110(1) states expressly that nothing in the provisions of the income tax legislation[18], other than Subdivision 815-B, limits the operation of that Subdivision.

[17] See the object of Subdivision 815-B in section 815-105.
[18] That is, the ITAA 1997 and the ITAA 1936.

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.

The debt and equity tests should prevail over the transfer pricing rules

32. Proponents of an alternative view argue the substitution of the arm's length conditions for the actual conditions under Subdivision 815-B should not affect the debt or equity characterisation under Division 974 of a financing transaction.

33. On this view, the characterisation of an interest under Division 974 prevails over the arm's length principle in Subdivision 815-B.

34. The contentions set out in paragraphs 35 to 43 of this draft Determination have been put forward to support this view.

Contention – subsection 815-110(1) should not be interpreted at face value

35. Firstly, subsection 815-110(1) cannot be taken literally in establishing the hierarchy of the provisions of the Act. Where more than one provision purports to apply for all purposes of the legislation and would produce different outcomes in a particular case to which they are applicable, they cannot all be taken at face value and some hierarchy needs to be established.

36. Secondly, the policy intent of other provisions may be defeated if the arm's length conditions are substituted under Subdivision 815-B automatically.

Commissioner's view

37. Subsection 815-110(1) needs to be interpreted consistently with the purpose of the Act as a whole.[19]

38. An application of Subdivision 815-B to a scheme for the purposes of working out the amount of the entity's taxable income, taxable loss of a particular sort, tax offsets and withholding tax payable does not interfere with the purpose of Division 974.[20] In particular, Subdivision 815-B[21] does not modify the tests of what constitutes a debt interest or an equity interest under Division 974.

39. Division 974 may need to be applied to both the actual conditions and the arm's length conditions to determine if an entity gets a transfer pricing benefit under Subdivision 815-B.[22] Accordingly, the application of Division 974 is not superseded by the operation of Subdivision 815-B.

40. The language of subsection 815-110(1) is clear and unambiguous. It ensures there is no conflict between Division 974 and Subdivision 815-B. The Commissioner's view is that any interpretation that reads down subsection 815-110(1) to enable an entity not to get

[19] *Acts Interpretation Act 1901* section 15AA. See also *Commissioner of Taxation v. Jayasinghe* [2016] FCAFC 79 per Allsop CJ at 3 to 12, *Channel Pastoral Holdings Pty Ltd v. Commissioner of Taxation* [2015] FCAFC 57 per Allsop at 3 to 7 and *Commissioner of Taxation v. Consolidated Media Holdings Ltd* [2012] HCA 55 at 39; 250 CLR 503 at 519.
[20] Section 815-120.
[21] Subsection 815-110(1) and section 815-115.
[22] Section 815-120.

a transfer pricing benefit through Division 974 would defeat the purpose of Subdivision 815-B. This includes cases where the arm's length conditions involve a scheme that results in a different debt or equity characterisation under Division 974 compared to the actual conditions.[23]

Contention – the transfer pricing rules and the debt-equity tests operate differently

41. The final contention is that transfer pricing rules and the debt equity tests operate in a number of ways that inherently conflict. In particular, the transfer pricing rules operate:

- on facts and circumstances, and
- year by year.

42. By contrast, the debt and equity rules operate:

- on pricing, terms and conditions, and
- once and for all to classify an arrangement until a material variation or conversion occurs.

Commissioner's view

43. The Commissioner disagrees that the two sets of provisions operate in conflict. The provisions can be read to operate harmoniously.

[23] Subsection 815-130(3).

Appendix 3 – Your comments

44. You are invited to comment on this draft Determination. Please forward your comments to the contact officers by the due date.

45. 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:

TD 2008/20; TR 92/11; TR 2006/10; TR 2014/6

Legislative references:

- ITAA 1997
- ITAA 1997 Subdiv 768-A
- ITAA 1997 768-5
- ITAA 1997 Subdiv 815-B
- ITAA 1997 815-105
- ITAA 1997 815-110
- ITAA 1997 815-110(1)
- ITAA 1997 815-115
- ITAA 1997 815-115(1)
- ITAA 1997 815-115(2)
- ITAA 1997 815-120
- ITAA 1997 815-120(1)
- ITAA 1997 815-125
- ITAA 1997 815-130
- ITAA 1997 815-130(3)
- ITAA 1997 815-140
- ITAA 1997 Div 974
- ITAA 1997 974-10
- ITAA 1997 974-10(1)
- ITAA 1997 974-20
- ITAA 1997 974-35
- ITAA 1997 974-35(1)(a)(ii)
- ITAA 1997 974-75
- ITAA 1997 974-75(1)
- ITAA 1997 974-120
- ITAA 1997 974-130
- ITAA 1936
- ITAA 1936 128AAA
- ITAA 1936 128B(1)
- Acts Interpretation Act 1901
- Acts Interpretation Act 1901 15AA

Cases relied on:

- Commissioner of Taxation v. Jayasinghe [2016] FCAFC 79; 2016 ATC 20-571
- Channel Pastoral Holdings Pty Ltd v. Federal Commissioner of Taxation [2015] FCAFC 57; 2015 ATC 20-503
- Federal Commissioner of Taxation v. Consolidated Media Holdings Ltd [2012] HCA 55; 250 CLR 503; (2012) 84 ATR 1; 2012 ATC 20-361

ATO references

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