

TD 2011/22 - Income tax: can Part IVA of the Income Tax Assessment Act 1936 apply to a scheme designed to convert otherwise assessable interest income into non-assessable non-exempt dividends?

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Taxation Determination

Income tax: can Part IVA of the *Income Tax Assessment Act 1936* apply to a scheme designed to convert otherwise assessable interest income into non-assessable non-exempt dividends?

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This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

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If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. Yes. Whilst the application of Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936)¹ to any particular arrangement depends on a careful weighing of all the relevant circumstances, Part IVA is likely to have application to arrangements similar to that described in paragraphs 2 to 6 of this Determination.

Example

2. *AusCo, an Australian resident company that is a subsidiary of an authorised deposit taking institution, borrows from an external source to acquire 100% of the ordinary shares issued by OffshoreCo, a non Australian resident company specifically incorporated for the transaction in question. OffshoreCo uses the funds it receives from the issue of its shares to make a loan to ForCo, a non Australian resident company unrelated to AusCo. ForCo uses those funds in its business activities. OffshoreCo's only function is to lend money.*

¹ All subsequent references in this Determination are to the ITAA 1936 unless indicated otherwise.

3. *AusCo ordinarily derives profits by lending money at a margin over its borrowing cost. Its previous dealings with ForCo involved the lending of monies and its objective in completing the transaction is to maintain its activities with ForCo on similar terms as those conducted in the past. The objective of ForCo is to obtain a loan to use in its business. ForCo is indifferent as to whether it makes interest repayments direct to AusCo or OffshoreCo. The operation of various aspects of the transaction are as follows:*

- (a) *dividends on the OffshoreCo ordinary shares are payable at the discretion of the directors;*
- (b) *both the directors and the shareholder of OffshoreCo can require the ordinary shares to be cancelled at any time. At the cancellation time the company must cancel the shares and return the fair market value of the shares to AusCo;*
- (c) *OffshoreCo does not have any employees although its directors are located in its country of incorporation;*
- (d) *ForCo's relationship with OffshoreCo grew out of activities conducted by employees of AusCo;*
- (e) *the risk assessment and consequent pricing of the loan between OffshoreCo and ForCo was conducted by employees of AusCo;*
- (f) *interest paid to OffshoreCo in respect of its loan to ForCo is not subject to withholding taxes in ForCo's country of tax residence;*
- (g) *interest derived by OffshoreCo in respect of its loan to ForCo is not subject to income taxes in OffshoreCo's country of tax residence; and*
- (h) *dividends on the OffshoreCo shares payable to AusCo are not subject to withholding taxes in OffshoreCo's country of tax residence.*

4. *Although dividends on the shares are payable at the discretion of the directors, OffshoreCo pays dividends, being the same amount as its interest receipts on the loan to ForCo, immediately after it receives the loan payments. These dividends allow AusCo to service its external borrowing and retain its lending margin.*

5. *It is assumed that the Australian tax result, but for the operation of Part IVA, is:²*

- (a) *dividends received by AusCo are non-assessable non-exempt (NANE) income pursuant to section 23AJ;*
- (b) *interest on AusCo's borrowings to fund its investment in OffshoreCo is deductible under section 25-90 of the Income Tax Assessment Act 1997 (ITAA 1997);*
- (c) *OffshoreCo carries on a financial intermediary business as defined in section 317;*
- (d) *even though OffshoreCo is a controlled foreign company and AusCo an attributable taxpayer, section 449 applies to exclude the interest income derived by OffshoreCo from the assessable income of AusCo; and*
- (e) *Part XI does not operate to assess AusCo on any income derived by OffshoreCo.³*

² The assumptions provided are not intended to define the Commissioner's view on the application of the law to all arrangements of this nature. The application of the law to any arrangement is dependent on the facts and circumstances and accordingly the Commissioner may apply the law in a manner contrary to the assumptions made depending on the facts and circumstances of each case.

6. *The use of OffshoreCo in the arrangement is partly explained by reference to AusCo's commercial objective, which is to set up a business to conduct lending activities offshore. In pursuing that objective, it is therefore necessary for OffshoreCo to be capitalised with ordinary equity which, by its nature is long term. It is noted however that OffshoreCo's only activity to date has been the lending of monies to ForCo and there has been no contemplation of future activities. Further, AusCo's equity in OffshoreCo can be liquidated at market value at short notice should the ForCo loan be repaid or a loan default event occur.*

Date of effect

7. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

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³ This assumption only applies up until the repeal of Part XI. Part XI has been repealed with effect from the 2010-11 year of income.

Appendix 1 – Explanation

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

Explanation

8. Part IVA allows the Commissioner to cancel all or part of a tax benefit that has been obtained, or would, but for section 177F, be obtained, by a taxpayer in connection with a scheme to which Part IVA applies. Part IVA applies if:

- (a) there is a scheme, as defined in section 177A;
- (b) a tax benefit, as identified in section 177C, was or would, but for subsection 177F(1), have been obtained in connection with the scheme; and
- (c) having regard to section 177D, the scheme is one to which Part IVA applies.

9. 'Scheme' is defined widely in section 177A to include any agreement, arrangement, understanding, promise or undertaking and any plan, proposal, action, course of action or course of conduct. The scheme in question would consist of the following:

- (a) activities undertaken in the preparation and establishment of OffshoreCo and the general transaction structure;
- (b) the establishment and settlement of the loan made by OffshoreCo;
- (c) the payment of interest on the loan provided by OffshoreCo to ForCo; and
- (d) the payment of dividends from OffshoreCo to AusCo.

10. Identifying the relevant tax benefit⁴ necessarily requires consideration of what would have happened or might reasonably be expected to have happened if the particular scheme had not been entered into or carried out. This is commonly described as the 'counterfactual'. In applying this 'reasonable expectation' test, it is useful to consider the most straightforward and usual way of achieving the intended commercial outcome of the scheme.

11. The objective of AusCo in entering the scheme is to derive a return from lending money. The objective of ForCo is to obtain a loan to use in its business activities and ForCo is indifferent as to whether it makes interest repayments direct to AusCo or OffshoreCo. Whilst the interposition of OffshoreCo in the arrangement may be partly explained by AusCo's objective of establishing a business to conduct lending activities offshore, the following aspects also exist:

- (a) there is an absence of activities leading to the generation of income from other clients for OffshoreCo;
- (b) OffshoreCo does not have any employees, rather the activities leading to the negotiation and settlement of the loan between ForCo and OffshoreCo were conducted by employees of AusCo;
- (c) the mechanisms in place for AusCo to liquidate its investment in OffshoreCo throughout the transaction run counter to the establishment of a permanent offshore platform for providing ongoing lending services; and

⁴ Further discussion on the meaning of tax benefit under Part IVA can be found at paragraphs 61 to 78 of Law Administration Practice Statement PS LA 2005/24 – Application of general anti-avoidance rules.

(d) OffshoreCo has not contemplated future lending activities.

12. These aspects support the conclusion that there are only minimal commercial reasons for the interposition of OffshoreCo in the ownership chain. The absence of significant commercial reasons for the interposition of OffshoreCo suggests its presence in the ownership chain is not the most straightforward way of achieving the objectives of AusCo in relation to the scheme.

13. Having regard to the objectives of the parties to the transaction, it might be reasonable to conclude that if the scheme had not been entered, AusCo would have made a loan directly to ForCo (rather than acquiring the issued shares in OffshoreCo) and consequently the interest received on the loan made by OffshoreCo would have been received directly by AusCo. It is therefore considered that the scheme would give rise to a tax benefit under paragraph 177C(1)(a), being the amount of interest received by OffshoreCo on the loan to ForCo which was not included in the assessable income of AusCo because of the scheme.⁵

14. Section 177D⁶ provides that Part IVA applies to a scheme in connection with which the taxpayer has obtained a tax benefit if, after having regard to the eight specified matters, it would be concluded that a person who entered into or carried out the scheme, or any part of it, did so for the purpose of enabling the taxpayer to obtain the tax benefit.

15. Whether the section 177D purpose test is satisfied depends on all the facts and circumstances. However, it would be reasonable to conclude, having regard to the matters set out in section 177D, that the sole or dominant purpose of AusCo in entering into or carrying out the scheme was to obtain a tax benefit. In this context the following observations can be made:

- (a) the manner in which the scheme was entered into is characterised by greater complexity than is commercially necessary. Given the absence of significant commercial reasons for the interposition of OffshoreCo in the arrangement, it may be concluded that the intention is to convert what would otherwise be assessable interest income into NANE dividend income (subparagraph 177D(b)(i));
- (b) AusCo's investment is, in legal form, equity. Its income is, in legal form, dividends. However, in substance, and consistent with its previous dealings with ForCo, AusCo's profits from the transaction and the risks it assumes from the transaction are economically consistent with those of a lender (subparagraph 177D(b)(ii));
- (c) the time at which the scheme was entered into and the length of the period during which the scheme was carried out are neutral and do not indicate a purpose of enabling AusCo to obtain a tax benefit (subparagraph 177D(b)(iii));
- (d) but for the operation of Part IVA, returns for AusCo in connection with the scheme would be NANE income (subparagraph 177D(b)(iv)); and

⁵ The counterfactual presented above represents a reasonable prediction given the objective of AusCo in undertaking the scheme. There may be other schemes exhibiting similar Australian tax characteristics where the evidence supports the counterfactual that nothing would have happened in Australia. See, for example, arrangements of the type described in Taxpayer Alert TA 2009/9, where the relevant tax benefit is identified as deductions claimed under section 25-90 of the ITAA 1997.

⁶ Further discussion on section 177D can be found at paragraphs 79 to 112 of PS LA 2005/24.

- (e) OffshoreCo is completely under the control of AusCo and operates as a mere conduit. It does not retain any capital as might be expected from an entity set up to conduct lending activities on any long term basis. This points to the prevailing purpose of entering into the scheme being to obtain the tax benefit in question (subparagraph 177D(b)(viii)).

16. Overall, the factors mentioned in subparagraphs 177D(b)(i), (ii), (iv) and (viii) point to a sole or dominant purpose of AusCo entering into the scheme to obtain a tax benefit. Subparagraph 177D(b)(iii) is neutral and the factors in subparagraphs 177D(b)(v), (vi) and (vii) are seemingly not relevant. Given this, it would be reasonable to conclude the sole or dominant purpose of AusCo in entering the transaction was to obtain a tax benefit.

17. In these circumstances the Commissioner would exercise his powers under subsection 177F(1) to cancel the tax benefit and determine that the whole of the income of derived by OffshoreCo in connection with its loan to the ForCo is assessable to AusCo.

References

Previous draft:

TD 2011/D2

Related Rulings/Determinations:

TR 2006/10

Subject references:

- anti avoidance
- arrangement
- controlled foreign company
- foreign investment fund
- non-assessable non-exempt income
- non-portfolio dividend
- Part IVA

Legislative references:

- ITAA 1936
- ITAA 1936 Pt IVA
- ITAA 1936 Pt XI
- ITAA 1936 23AJ
- ITAA 1936 177A
- ITAA 1936 177C

- ITAA 1936 177C(i)(a)
- ITAA 1936 177D
- ITAA 1936 177D(b)(i)
- ITAA 1936 177D(b)(ii)
- ITAA 1936 177D(b)(iii)
- ITAA 1936 177D(b)(iv)
- ITAA 1936 177D(b)(v)
- ITAA 1936 177D(b)(vi)
- ITAA 1936 177D(b)(vii)
- ITAA 1936 177D(b)(viii)
- ITAA 1936 177F
- ITAA 1936 177F(1)
- ITAA 1936 317
- ITAA 1936 449
- ITAA 1997 25-90

Other references:

- Law Administration Practice Statement
PS LA 2005/24
- Taxpayer Alert TA 2009/9

ATO references

NO:	1-2TU3W0G
ISSN:	1038-8982
ATOlaw topic:	Income Tax ~~ Tax integrity measures ~~ schemes Income Tax ~~ Tax integrity measures ~~ controlled foreign companies Income Tax ~~ Tax integrity measures ~~ foreign investment funds