


TD 2005/D20 - Income tax: for the purposes of Division 974 of the Income Tax Assessment Act 1997, if the issuer of an interest bearing instrument can change the rate of interest that will become payable to any rate (including zero) that it chooses at its sole discretion, does the issuer have an 'effectively non-contingent obligation' to provide 'financial benefits' as interest payments from the time that a change in the interest rate could take effect?

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This document has been finalised by [TD 2006/1](#).



Draft Taxation Determination

Income tax: for the purposes of Division 974 of the *Income Tax Assessment Act 1997*, if the issuer of an interest bearing instrument can change the rate of interest that will become payable to any rate (including zero) that it chooses at its sole discretion, does the issuer have an ‘effectively non-contingent obligation’ to provide ‘financial benefits’ as interest payments from the time that a change in the interest rate could take effect?

Preamble

*This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVA of the **Taxation Administration Act 1953**. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

1. No, unless the issuer’s ostensibly unfettered discretion to change the interest rate should be disregarded in the light of the full consideration of the pricing, terms and conditions of the scheme under which the instrument was issued. This Taxation Determination does not apply if the holder of the instrument can compel the issuer to return the amount invested in the instrument on any occasion that the issuer changes the interest rate.
2. One of the objects of Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) is to establish a test for determining for particular tax purposes whether a scheme gives rise to a debt interest (paragraph 974-10(1)(a) of the ITAA 1997). The test is contained in section 974-20 of the ITAA 1997: it sets out five criteria that must be satisfied before a scheme gives rise to a debt interest in an entity. These tests are to be applied when the scheme that gives rise to the interest comes into existence or is changed (subsection 974-15(1) and section 974-110 of the ITAA 1997 respectively).
3. One of the tests is that the entity must have an ‘effectively non-contingent obligation’ under that scheme to provide a financial benefit or benefits (paragraph 974-20(1)(c) of the ITAA 1997).

4. An issuer has an ‘effectively non-contingent obligation’ to take an action under a scheme where, having regard to the pricing, terms and conditions of the scheme, there is in substance or effect a non-contingent obligation to take that action (subsection 974-135(1) of the ITAA 1997).

5. The term ‘financial benefit’ means anything of economic value (section 974-160 of the ITAA 1997). The provision of a financial benefit will include the payment of an amount of money, and payments of interest will be financial benefits.

6. Another of the five key tests of a debt interest is that it is substantially more likely than not that the value of the financial benefits to be provided by a relevant entity (and this includes the issuer) will be at least equal to the value received (paragraph 974-20(1)(d) of the ITAA 1997). Particular rules apply to the valuation of financial benefits (see sections 974-35, 974-40, 974-45 and 974-50 of the ITAA 1997).

7. If a company issues an instrument under a scheme that is a financing arrangement for the company, and the amount of the return is variable at the discretion of the company, the instrument will be an equity interest in the company unless the debt test is also satisfied (subsections 974-70(1) and 974-75(2) of the ITAA 1997; item 3 in the table in subsection 974-75(1) of the ITAA 1997). However, if the instrument satisfies the debt test, it will be treated as a debt interest and not an equity interest (subsection 974-5(4) of the ITAA 1997).

8. The terms and conditions of some ‘resettable’ instruments give the issuer an apparently unlimited discretion to change (that is, to ‘reset’) the rates of interest payable after a certain period. Further, on any occasion that the rates are reset, the holders of these particular instruments cannot compel the issuer to return the amounts that they have invested in the instruments.

9. This type of interest will satisfy the equity test if it is issued by a company, because the amount of the return will be variable at the discretion of the company and the interest will fall within item 3 in the table in subsection 974-75(1) of the ITAA 1997. It will therefore be an equity interest unless the debt test is also satisfied, in which case it will be a debt interest (paragraph 974-70(1)(b) and subsection 974-5(4) of the ITAA 1997).

10. The terms and conditions of the instruments mentioned in paragraph 8 give the issuer an unfettered discretion to reset the interest rate. The issuer can set a new rate of interest to apply after the reset that is substantially less than the prevailing market rate. The issuer can even choose to reset the rate to zero. The payment of any interest after the reset date will thus be contingent upon the issuer choosing to reset the rate to a rate that is greater than zero.

11. In these circumstances, at the time that the instrument is issued it is not possible to identify any amounts of periodic interest that the issuer will be effectively obliged to pay after the reset date. The terms and conditions of the instrument give the issuer an effective choice about the payment of any interest after that date. Because the issuer has an effective choice about the provision of those particular financial benefits, there is not an effectively non-contingent obligation to provide financial benefits as periodic interest payments after the time that the choice might take effect.

12. However, the issuer might have an effectively non-contingent obligation to provide periodic interest payments before the interest rate on the instrument can be reset, and/or to pay back the amount invested in the instrument at some time. Whether any obligation to make such payments would be sufficient to satisfy the debt test, so that the instrument would be a debt interest (and not an equity interest), will depend on the value of those financial benefits, and the satisfaction of other elements of the debt test.

13. It has been suggested that any prospect that an issuer of an instrument that is subject to the terms and conditions described in paragraph 8 might choose to reset the interest rate to a zero rate, or even a rate that is below market rates, should be ignored as being immaterially remote, because the issuer would suffer substantial adverse commercial consequences if it were to set rates at those levels. Accordingly, so it is said, the issuer's right to choose a zero rate, or rate that is less than the market rate, should be disregarded, and the issuer should be considered to have an effectively non-contingent obligation to provide interest at no less than market rates after the reset dates.

14. However, subsection 974-135(7) of the ITAA 1997 explicitly provides that an obligation is not effectively non-contingent merely because a party will suffer detrimental practical or commercial consequences if they do not fulfil that obligation. That is, where an obligation to provide a financial benefit is contingent, the obligation will not be rendered 'effectively non-contingent' merely because of the practical and commercial detriment that will follow if that financial benefit is not provided. In the circumstances that are the subject of this Taxation Determination, the provision of any financial benefits as periodic interest after the reset takes effect is contingent upon the issuer resetting the rate at a rate in excess of zero. It may well be that an issuer will suffer detrimental practical or commercial consequences if it resets the rate at less than market rates. The application of subsection 974-135(7) means that the prospect of any practical or commercial detriment that will arise if the interest rate is reset to zero, or less than a market rate, will not render the contingent obligation to provide financial benefits effectively non-contingent for the purposes of Division 974 of the ITAA 1997.

Example

15. *Company A issues notes that have a fixed term to maturity of 20 years, for a subscription price of \$100.00 each, which is repayable only at maturity. The initial interest rate is set by Company A at 8% per year for a fixed period of 5 years. Company A must pay a total of \$40 interest over this initial 5 year period. At the end of the first 5 years, Company A can set a new interest rate at its sole discretion. At the time of issue of the notes, proper consideration of the substance or effect of the pricing, terms and conditions does not lead to the conclusion that the company's unfettered discretion to change the interest rate should be disregarded.*

16. *The debt test is applied when the scheme comes into existence – in this case, when the notes are issued. The issuer has an effectively non-contingent obligation to provide the following financial benefits:*

<i>Years 1 to 5:</i>	<i>\$8.00 per year as interest</i>
<i>Year 20:</i>	<i>\$100.00 as the return of the subscription price paid for the notes at maturity</i>

The issuer does not have an effectively non-contingent obligation to provide financial benefits as periodic interest payments in years 6 to 20.

Whether the obligation to pay \$140.00 as financial benefits is sufficient to satisfy the debt test, so that the notes would be debt interests, will depend on the application of other elements of the debt test.

Date of effect

17. 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 21 and 22 of Taxation Ruling TR 92/20).

Your comments

18. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

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Commissioner of Taxation

20 July 2005

<i>Previous draft:</i>	- ITAA 1997 974-10(1)(a)
	- ITAA 1997 974-15(1)
Not previously issued as a draft	- ITAA 1997 974-20
	- ITAA 1997 974-20(1)(c)
<i>Related Rulings/Determinations:</i>	- ITAA 1997 974-20(1)(d)
TR 92/20	- ITAA 1997 974-35
	- ITAA 1997 974-40
<i>Subject references:</i>	- ITAA 1997 974-45
- debt interest	- ITAA 1997 974-50
- effectively non-contingent obligation	- ITAA 1997 974-70(1)
- equity interest	- ITAA 1997 974-70(1)(b)
- financial benefit	- ITAA 1997 974-75(1)
- resettable instruments	- ITAA 1997 974-75(2)
	- ITAA 1997 974-110
<i>Legislative references:</i>	- ITAA 1997 974-135(1)
- TAA 1953 Pt IVAAA	- ITAA 1997 974-135(7)
- ITAA 1997 Div 974	- ITAA 1997 974-160
- ITAA 1997 974-5(4)	

ATO references

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