TD 2009/D8 - Income tax: to obtain a deduction under section 25-90 of the Income Tax Assessment Act 1997 for a cost in relation to a debt interest does the taxpayer have to actually derive a dividend to which section 23AJ of the Income Tax Assessment Act 1936 applies in the same income year as that in which the cost is incurred?

This document has been finalised by TD 2009/21.

There is a Compendium for this document: **TD 2009/21EC** .

Draft Taxation Determination

Income tax: to obtain a deduction under section 25-90 of the *Income Tax Assessment Act 1997* for a cost in relation to a debt interest does the taxpayer have to actually derive a dividend to which section 23AJ of the *Income Tax Assessment Act 1936* applies in the same income year as that in which the cost is incurred?

This publication provides you with the following level of protection:

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.

You can rely on this publication (excluding appendixes) to provide you with protection from interest and penalties in the following way. If a statement turns out to be incorrect and you underpay your tax as a result, you will not have to pay a penalty. Nor will you have to pay interest on the underpayment provided you reasonably relied on the publication in good faith. However, even if you don't have to pay a penalty or interest, you will have to pay the correct amount of tax provided the time limits under the law allow it.

Ruling

1. No, to obtain a deduction under section 25-90 of the *Income Tax Assessment Act 1997* (ITAA 1997) it is not necessary for a taxpayer to actually derive a dividend to which section 23AJ of the *Income Tax Assessment Act 1936* (ITAA 1936) applies in the same income year as that in which the cost is incurred.

2. However, there must be a sufficiently clear nexus between the relevant cost and either the production of an actual section 23AJ dividend[1] in the year the cost was incurred or an expected section 23AJ dividend in a future income year. For there to be such a nexus there must be (during the relevant period, which may be greater than one income year) a reasonable expectation, together with a more than theoretical potential, that dividends of the relevant kind will be paid to the taxpayer incurring the costs, albeit in the future. This is a question of fact that requires a careful consideration of all the objective circumstances of each particular case.

[1] In this draft Determination a reference to a section 23AJ dividend is a reference to a dividend that satisfies all the criteria in section 23AJ of the ITAA 1936.

3. This draft Determination does not address the question of the amount of the deduction (if any) available under section 25-90 of the ITAA 1997: this is a question of fact to be decided by having regard to all the objective circumstances of each situation.

Date of effect

4. 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 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
16 September 2009

Appendix 1 – Explanation

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

5. Section 25-90 of the ITAA 1997 provides:

> An *Australian entity can deduct an amount of loss or outgoing from its assessable income for an income year if:
>
> (a) the amount is incurred by the entity in deriving income from a foreign source; and
>
> (b) the income is *non-assessable non-exempt income under section 23AI, 23AJ or 23AK of the *Income Tax Assessment Act 1936*; and
>
> (c) the amount is a cost in relation to a *debt interest issued by the entity that is covered by paragraph (1)(a) of the definition of ***debt deduction***.

6. Section 25-90 of the ITAA 1997 is a standalone deduction provision concerned with losses and outgoings that are particular types of 'costs' in relation to debt interests.[2] The words of the provision must not be read in isolation, but in context, in the widest sense of that word. Therefore it is necessary to consider the words in the textual context of the tax law, and also in the context of the law before the provision was enacted, and to discover the mischief intended to be remedied.[3]

7. In paragraph 25-90(a) of the ITAA 1997, the phrase 'in deriving'[4] creates a requirement for a specific type of nexus between the 'cost' that has been incurred in relation to the debt interest and the foreign source income covered by paragraph 25-90(b) of the ITAA 1997 (for example, section 23AJ dividends). The use of the verb form 'in deriving' suggests that the nexus is concerned with identifying costs that form part of the process of income derivation, rather than being concerned with a particular occasion of actual derivation. If deductions under section 25-90 of the ITAA 1997 were intended to be limited to income years in which the relevant foreign income was actually derived, one would have expected to see a different emphasis in the wording of the provision.

8. Such a conclusion finds additional support in the overall structure and wording of the provision. For example, section 25-90 of the ITAA 1997 does not expressly require a temporal nexus between the incurring of the cost and the actual derivation of a section 23AJ dividend. Nor does it expressly state the income year in which the deduction is available. As a general rule the tax system recognises a deduction in the year in which the expense arises or is otherwise incurred. If an alternative result is intended then the legislation will generally specify the year or years in which the deduction is recognised. All this suggests that a temporal matching to the actual receipt of income was not intended.

---

[2] There is nothing in the wording of section 25-90 of the ITAA 1997 that requires the section to be read as if it was subject to the express or implied limitations to be found in section 8-1 of the ITAA 1997. Section 25-90 must be read on its own terms.

[3] *CIC Insurance Ltd v. Bankstown Football Club Limited* (1995) 187 CLR 384 at 408

[4] The word derive and its cognate expressions take their meaning from the statutory context in which they appear, rather than from reliance upon past authorities which considered a different statutory context; *FC of T v. Sun Alliance Investments Pty Ltd (in liq)* 2005 ATC 4953 at [45]. Consequently, while there may be a general presumption that a word will be used consistently within the same legislative enactment that presumption is easily rebutted; *Commissioner of Taxes (Vic) v. Lennon* (1921) 29 CLR 579 at 590 Higgins J and more recently *McGraw-Hinds (Aust) Pty Ltd v. Smith* (1978) 144 CLR 633 at 643 per Gibbs ACJ.

9. Section 25-90 of the ITAA 1997 was introduced at the same time as the broader thin capitalisation regime, and was intended to operate in the context of that regime. Prior to the enactment of these provisions the tax law imposed limitations on debt deductions incurred in funding foreign subsidiaries through the general deduction rule in section 8-1 of the ITAA 1997. That provision denied deductions for costs incurred in earning exempt foreign income. There were also provisions that quarantined certain types of deductions. All these provisions were prone to circumvention by careful tax planning. The fundamental intention of section 25-90 was that, in respect of certain categories of foreign source income, taxpayers should be able to achieve in a straight-forward manner what they could already practically achieve in a roundabout manner under the existing law.

10. Therefore on balance it is considered that section 25-90 of the ITAA 1997 does not require a form of temporal matching between expenses and specific income.

11. Specifically in relation to section 23AJ dividends, the section does not require that such a dividend actually be derived in the income year in which the cost is incurred. It is enough if there is a sufficiently clear nexus between the relevant cost and either the production of an actual section 23AJ dividend in the year the cost was incurred or an expected section 23AJ dividend in a future income year. The existence of such a nexus is a question of fact to be decided by having regard to all the objective circumstances in each case.

12. Additionally, an expectation of a future section 23AJ dividend must be reasonable and not a mere theoretical possibility; that is there must be a reasonable prospect of section 23AJ dividends. In this context it is necessary to consider whether there was, during the relevant period (which may be greater than one income year), an expectation and intention as well as the potential for dividends of the relevant kind to be paid to the taxpayer incurring the costs, albeit in the future. Whether such an intention and potential exists is a question of fact to be decided having regard to all the objective circumstances in each particular case.

13. While by no means exhaustive, it is considered that at a practical level all of the elements set out below would need to be present before there can be a reasonable expectation that a section 23AJ dividend will be derived in a future income year.

- In the income year in which the cost is incurred, the taxpayer must hold interests in an entity of the kind that could result in the derivation of income covered by section 23AJ of the ITAA 1936.
- If a distribution were made in that income year in respect of that investment, it would be a section 23AJ dividend.
- The company in which the interests are held currently has retained profits, or is likely to have profits in a future income year, that could be used to pay a section 23AJ dividend in respect of the interests held by the taxpayer.
- There are objective reasons to believe that the company is more likely than not to use such profits to pay a dividend in the future.

Appendix 2 – Your comments

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

15. A compendium of comments is also 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
- publish on the Tax Office 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:	**16 October 2009**
Contact officer:	**Catherine Radley**
Email address:	**Catherine.Radley@ato.gov.au**
Telephone:	**(02) 6216 2502**
Facsimile:	**(02) 6216 1250**
Address:	**Australian Taxation Office** **PO Box 9977** **Civic Square ACT 2608**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- debt deduction
- deriving
- incurred
- loss or outgoing

Legislative references:

- ITAA 1936 23AJ
- ITAA 1997 8-1
- ITAA 1997 25-90
- ITAA 1997 25-90(a)
- ITAA 1997 25-90(b)
- ITAA 1997 25-90(c)

Case references:

- CIC Insurance Ltd v. Bankstown Football Club Limited (1995) 187 CLR 384
- Commissioner of Taxes (Vic) v. Lennon (1921) 29 CLR 579 (1921) 28 ALR 25
- FC of T v. Sun Alliance Investments Pty Ltd (in liq) 2005 ATC 4953, 60 ATR 560
- McGraw-Hinds (Aust) Pty Ltd v. Smith (1979) 144 CLR 633, (1979) 24 ALR 175

ATO references

NO: 1-1PVRNRT
ISSN: 1038-8982
ATOlaw topic: Income Tax ~~ Assessable income - foreign sourced Income Tax ~~ Assessable income ~~ derivation of income