



TD 2014/D18 - Income tax: will paragraph 974-80(1)(d) of the Income Tax Assessment Act 1997 be satisfied merely because a non-resident entity has chosen to invest indirectly in a debt interest issued by an Australian resident company and there is one or more equity interests interposed between the non-resident entity and the entity holding the debt interest?

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This document has been finalised by TD 2015/2.

 There is a Compendium for this document: TD 2015/2EC .



Draft Taxation Determination

Income tax: will paragraph 974-80(1)(d) of the *Income Tax Assessment Act 1997* be satisfied merely because a non-resident entity has chosen to invest indirectly in a debt interest issued by an Australian resident company and there is one or more equity interests interposed between the non-resident entity and the entity holding the debt interest?

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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.

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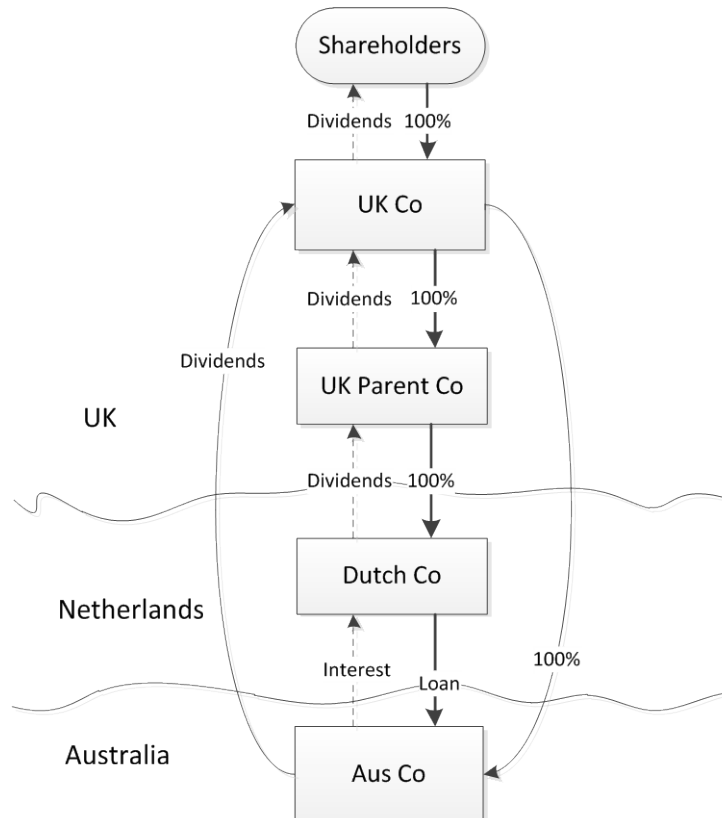
Ruling

1. No. The fact that a non-resident entity has decided to invest indirectly in an Australian resident company through one or more interposed entities and the final leg in the chain is a debt interest will not of itself be sufficient to form a conclusion under paragraph 974-80(1)(d)¹ that there is a scheme, or a series of schemes, designed to operate so that the returns on the debt interest are used to fund returns on an equity interest held by another person (the 'ultimate recipient').

¹ All legislative references are to the *Income Tax Assessment Act* (ITAA 1997) unless otherwise indicated.

Example 1

2. Examples 1 and 2 are based on the following diagram:



3. *UK Co is a widely held United Kingdom resident company.*
4. *UK Co wholly owns another UK company, UK Parent Co.*
5. *UK Parent Co is the holding company for the group's non-UK resident entities.*
6. *UK Parent Co incorporates a special purpose company in the Netherlands, Dutch Co, in order to acquire a debt interest in an existing Australian resident subsidiary of UK Co, Aus Co.*
7. *UK Parent Co contributes \$100 to acquire all the issued shares in Dutch Co.*
8. *Dutch Co uses the funds contributed by UK Parent Co to acquire the debt interest.*
9. *UK Parent Co, Dutch Co, and Aus Co are connected entities of UK Co as defined in subsection 995-1(1).*
10. *Aus Co pays interest to Dutch Co pursuant to the loan agreement between Dutch Co to Aus Co.*
11. *Dutch Co in turn pays dividends to UK Parent Co.*
12. *UK Parent Co pays dividends to UK Co out of a pool of dividends received from subsidiaries, including Dutch Co.*
13. *UK Co pays dividends to its shareholders.*

14. *Paragraph 974-80(1)(d) will not be satisfied. Whilst the interest payments from Aus Co to Dutch Co will be a source of funds for Dutch Co which will ultimately be used as part of a pool of funds by UK Parent Co to pay dividends to UK Co shareholders, it is an insufficient basis for a conclusion that the scheme or series of schemes is designed to operate so that the return to Dutch Co is used to fund dividends to UK Parent Co. In order for paragraph 974-80(1)(d) to be satisfied there must be a stronger connection between the payments of interest and payment of dividends which is evident from the way the scheme is structured such that it is reasonable to conclude that the dividends paid to shareholders in UK Co are indirectly a return from Aus Co.*

Example 2

15. *In Example 1, assume that Dutch Co acquires a new Australian resident subsidiary, Aus Co by acquiring all the shares in Aus Co for \$100 as well as acquiring a new debt interest for \$100.*

16. *For the reasons given in Example 1, paragraph 974-80(1)(d) will not be satisfied.*

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 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

12 November 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.*

Explanation

18. Division 974 contains rules for classifying an interest as debt or equity for certain tax purposes. Section 974-80 is an integrity provision within Division 974. It deals with financing arrangements that grant an investor (the ultimate recipient) an interest which is effectively (in substance but not in form), an equity interest in a company. The provision applies when the equity-like returns that are paid to the ultimate recipient are funded from otherwise tax deductible payments made by the company.² That is, where interposed debt interests are used to create 'de facto' equity interests, the provision reclassifies the interposed debt interests as equity interests. This causes the returns paid in respect of those same interests to be non-deductible.³

19. In order for section 974-80 to apply, all the requirements in subsection 974-80(1) must be satisfied. Firstly, there must be an interest that carries a right to a variable or fixed rate of return: paragraph 974-80(1)(a). Secondly, that interest must be held by a connected entity⁴ of the company: paragraph 974-80(1)(b). Thirdly, the interest must not otherwise be an equity interest: paragraph 974-80(1)(c). Fourthly, the scheme that gives rise to the interest must be a financing arrangement:⁵ paragraph 974-80(1)(ca). Finally paragraph 974-80(1)(d) requires that:

there is a scheme, or a series of schemes, designed to operate so that the return to the connected entity is to be used to fund (directly or indirectly) a return to another person (the *ultimate recipient*).

20. It has been argued that the test in paragraph 974-80(1)(d) can be satisfied in cases where an entity has chosen to invest indirectly in a debt interest issued by an Australian resident company. In other words, where an entity chooses to invest indirectly through one or more connected entities, then it must be concluded that there is a scheme, or a series of schemes designed to operate so that the return on the debt interest is to be used to fund equity returns to the entity's shareholders.

21. The Commissioner does not agree with that argument. The Commissioner considers that paragraph 974-80(1)(d) will be satisfied where it can be established, objectively, that the financing arrangement for a company, either of itself or together with other schemes, has been structured to enable returns to be paid by the company to the ultimate recipient such that it is reasonable to conclude that the ultimate recipient is in-substance receiving returns from the company, albeit indirectly.

² See paragraphs 2.41 to 2.49 of the Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001. See also paragraphs 1.27 to 1.29 of the Supplementary Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001.

³ Section 26-26 provides that a company cannot deduct:

- a non-share distribution, or a return that has accrued on a non-share equity interest; or
- a dividend paid on an equity interest in the company as a general deduction under the Act.

⁴ 'Connected entity' is defined in section 995-1.

⁵ 'Financing Arrangement' is defined in section 974-130.

22. Paragraph 974-80(1)(d) will not be satisfied merely because the funding arrangement will result in returns paid by the company on the debt interest being one potential source of funds which will ultimately fund returns on equity interests in the ultimate parent entity.

23. Absent evidence suggesting otherwise, the return on the debt interest paid by the Australian entity is merely a source of funds which may be used by the parent entity to fund equity returns. As such, it would not be reasonable to conclude that the ultimate recipient (that is, the shareholder) is in-substance receiving de facto equity returns from the Australian company and thus there would not be a scheme, or series of schemes, under which returns paid by the Australian entity on the debt interests were designed to be the source of funds to fund returns on the equity interests held by the ultimate recipients.

Appendix 2 – Your comments

24. 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.

25. 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.

Due date:	12 December 2014
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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 2006/10

Subject references:

- debt test
- equity test

Legislative references:

- ITAA 1997
- ITAA 1997 26-26
- ITAA 1997 Div 974
- ITAA 1997 974-80
- ITAA 1997 974-80(1)
- ITAA 1997 974-80(1)(a)

- ITAA 1997 974-80(1)(b)
- ITAA 1997 974-80(1)(c)
- ITAA 1997 974-80(1)(ca)
- ITAA 1997 974-80(1)(d)
- ITAA 1997 974-130
- ITAA 1997 995-1
- ITAA 1997 995-1(1)

Other references:

- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001
- Supplementary Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001

ATO references

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