TA 2009/9 - Contrived cross-border arrangements that seek to generate debt deductions for non-assessable non-exempt income

Australian Government
Australian Taxation Office

Taxpayer Alert TA 2009/9

This updated version of TA 2009/9 supersedes the previously published version.

FOI status: may be released

Taxpayer Alerts are intended to be an 'early warning' of significant new and emerging higher risk tax planning issues or arrangements that the Australian Taxation Office (ATO) has under risk assessment, or where there are recurrences of arrangements that have been previously risk assessed.

Taxpayer Alerts will provide information that is in the interests of an open tax administration to taxpayers. Taxpayer Alerts are written principally for taxpayers and their advisers and they also serve to inform tax officers of new and emerging higher risk tax planning issues. Not all potential tax planning issues that the ATO has under risk assessment will be the subject of a Taxpayer Alert, and some arrangements that are the subject of a Taxpayer Alert may on further examination be found not to be of concern to the ATO. In these latter cases the Taxpayer Alert will be withdrawn and a notification published which will be referenced to that Taxpayer Alert.

Taxpayer Alerts will give the title of the issue (which may be a scheme, arrangement or particular transaction), briefly describe the issue and will highlight the features which are of concern to the ATO. These issues will generally require more detailed analysis to provide the ATO view to taxpayers.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in this Taxpayer Alert can seek a formal determination of the ATO's position through a private ruling). Such taxpayers might also contact the tax officer named in the Taxpayer Alert and/or obtain their own advice.

This Taxpayer Alert is issued under the authority of the Commissioner.

Title Contrived cross-border arrangements that seek to generate debt deductions for non-assessable non-exempt income

This Taxpayer Alert describes certain cross-border financing arrangements which seek to generate debt deductions in Australia. These arrangements have little or no commercial or economic purpose and appear to be driven by the tax benefits that arise under section 25-90 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Section 25-90 of the ITAA 1997 allows a deduction for an amount or outgoing that is a cost in relation to debt interests where the cost is incurred in deriving non-assessable non-exempt income under section 23AI, 23AJ or 23AK of the *Income Tax Assessment Act 1936* (ITAA 1936).

This Alert focuses on blatant, artificial and contrived cross-border financing arrangements that attempt to generate a deduction under section 25-90 for costs incurred in deriving non-assessable non-exempt dividends under section 23AJ of the ITAA 1936.

DESCRIPTION

1. Arrangements covered by this Alert show at least one, but may show several, of the following relevant criteria:

a. the arrangement which is returning non-assessable non-exempt income is in substance the provision of financial accommodation to an unrelated party and by contrivance the return for the provision of financial accommodation is made a non-portfolio dividend from a related party;

b. the arrangement which is returning non-assessable non-exempt income is in substance an investment by a non-resident entity in another non-resident entity, where Australia is artificially interposed in the investment to secure a tax deduction matched by non-assessable income;

c. the arrangement which is returning non-assessable non-exempt income is in substance an investment by an Australian resident in another Australian resident, and a non-portfolio investment in a non-resident company is artificially interposed in the investment to secure non-assessable income;

d. the arrangement which is returning non-assessable non-exempt income is designed to match the income with the cost deducted under section 25-90 to secure a '"free" tax deduction. Funds advanced under the arrangement are effectively returned to the provider of the funds, or an associate. Promissory notes or other non-cash means of making advances may be employed;

e. the structure used in the arrangement is unduly complex or contrived - an example of such complexity is where an entity is interposed into the arrangement structure where such interposition is unnecessary from a commercial viewpoint. In some cases, the Australian resident may be instructed by the marketer or lender to add apparently unnecessary layers of complexity to the financing arrangement;

f. absent the tax benefits, the arrangement has little or no commercial or economic purpose;

g. the flow of funds in the arrangement is circular, so that the funds ultimately flow back to the initial investor or lender (for example, a borrowing from the capital markets may be linked to the counterparty to the transaction); **or,**

h. there may be no commercial reason for involving an Australian resident entity in the transaction - that is, in an ordinary commercial arrangement the foreign entity would not have sourced its investment from Australia. For example, the arrangement might economically be an investment from Europe into Asia but routed through Australia apparently for the dominant purpose of obtaining tax benefits available under section 25-90 of the ITAA 1997; **and**

i. deductions are claimed under section 25-90 in respect of costs incurred in deriving the non-assessable non-exempt income.

2. Relevant arrangements may also include one or more of the following features:

a. many or all of the participants in the arrangement are related parties;

b. the transaction may be structured in a manner such that no income or minimal income is included in the assessable income of the Australian resident entity under the controlled foreign company (CFC) and foreign investment fund (FIF) provisions;

c. in economic substance, the income received from the non-resident entity is more like interest rather than a share of business profits;

d. the net pre-tax return on the investment is less than the target rates of return of the entity in its general business;

e. the return from the non-resident entity has been structured to eliminate the operational and market risk that would normally be expected from commercial business transactions;

f. in the case of an investment by way of redeemable preference shares, returns are predetermined and the Australian entity is not entitled to participate in any upside of the investment;

g. where the transaction structure has a variable element such as a floating return or variable rate of interest, this may be swapped for a fixed return or cost to lock in the income and fix the tax benefits generated by the arrangement; **or,**

h. the transaction may be structured so that no tax or minimal tax is paid in the offshore jurisdiction. This includes arrangements where tax is paid offshore and then claimed back as a credit by an associated non-resident entity.

3. Some arrangements involve a third party who, although *prima facie* at arm's length, participates in the arrangement in order to share the tax benefits generated by the arrangement.

4. Such a third party will often be a marketer of the arrangement and will receive a fee that will generally take the form of a commercial return associated with the arrangement. In substance that commercial return will often be a disguised fee for marketing the arrangement.

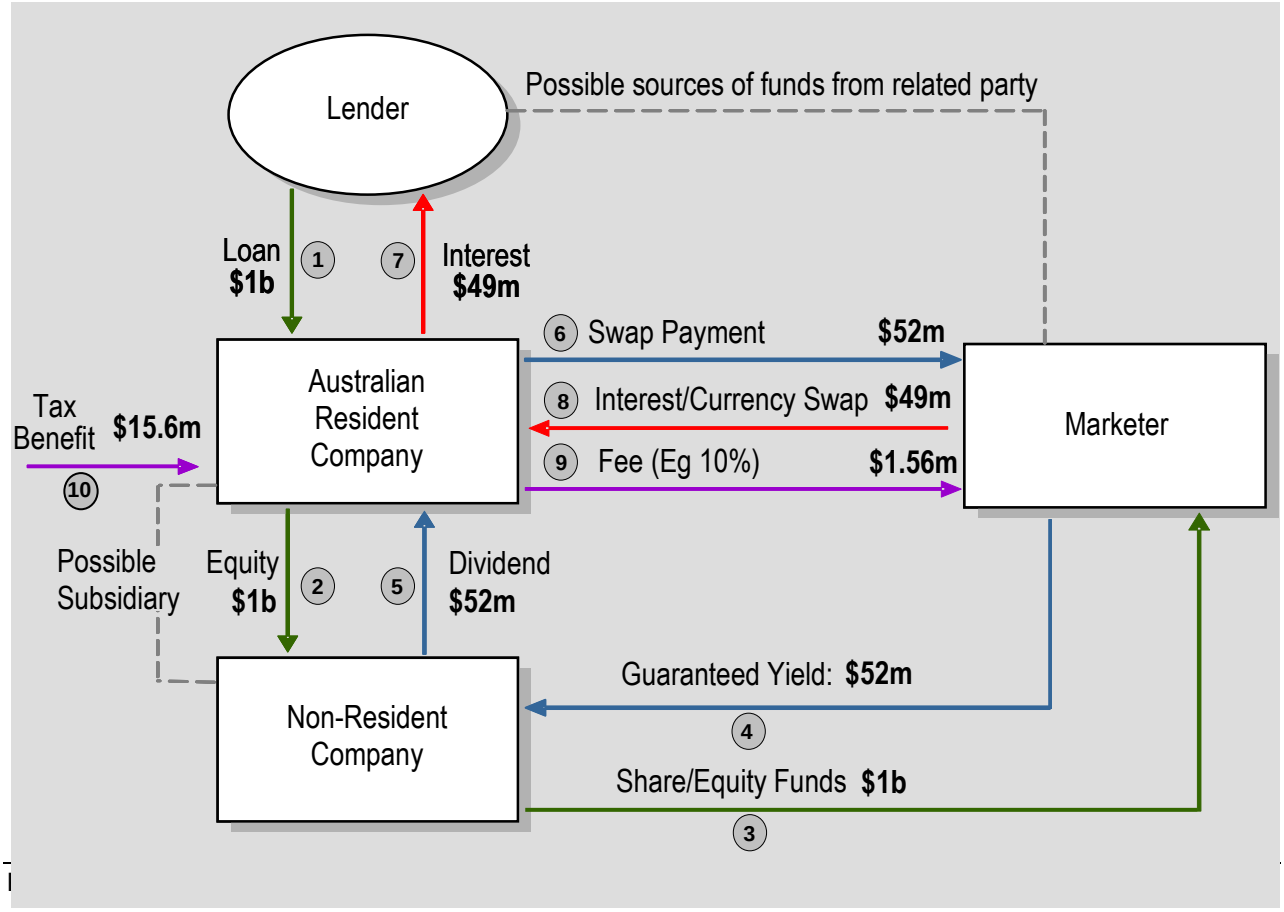
EXAMPLES OF TYPICAL DEBT DEDUCTION GENERATOR ARRANGEMENTS

Example 1

1. The Australian resident entity enters into the arrangement by borrowing funds (in this example, $1bn) from the capital markets or from a related party with the intention of using the funds to obtain equity in a non-resident entity. In some cases, it appears that the borrowed funds may be sourced from the marketer of the arrangement. In other cases, it appears that the funds are borrowed short-term and that all or a substantial part of the funds quickly flow back to the lender via a series of back to back steps in the transaction structure.

2. The marketer of the arrangement agrees to effectively return part of its fee to the non-resident entity. This part of the fee is then returned to the Australian resident as non-assessable non-exempt income and provides the Australian resident with an apparent commercial return on their investment.

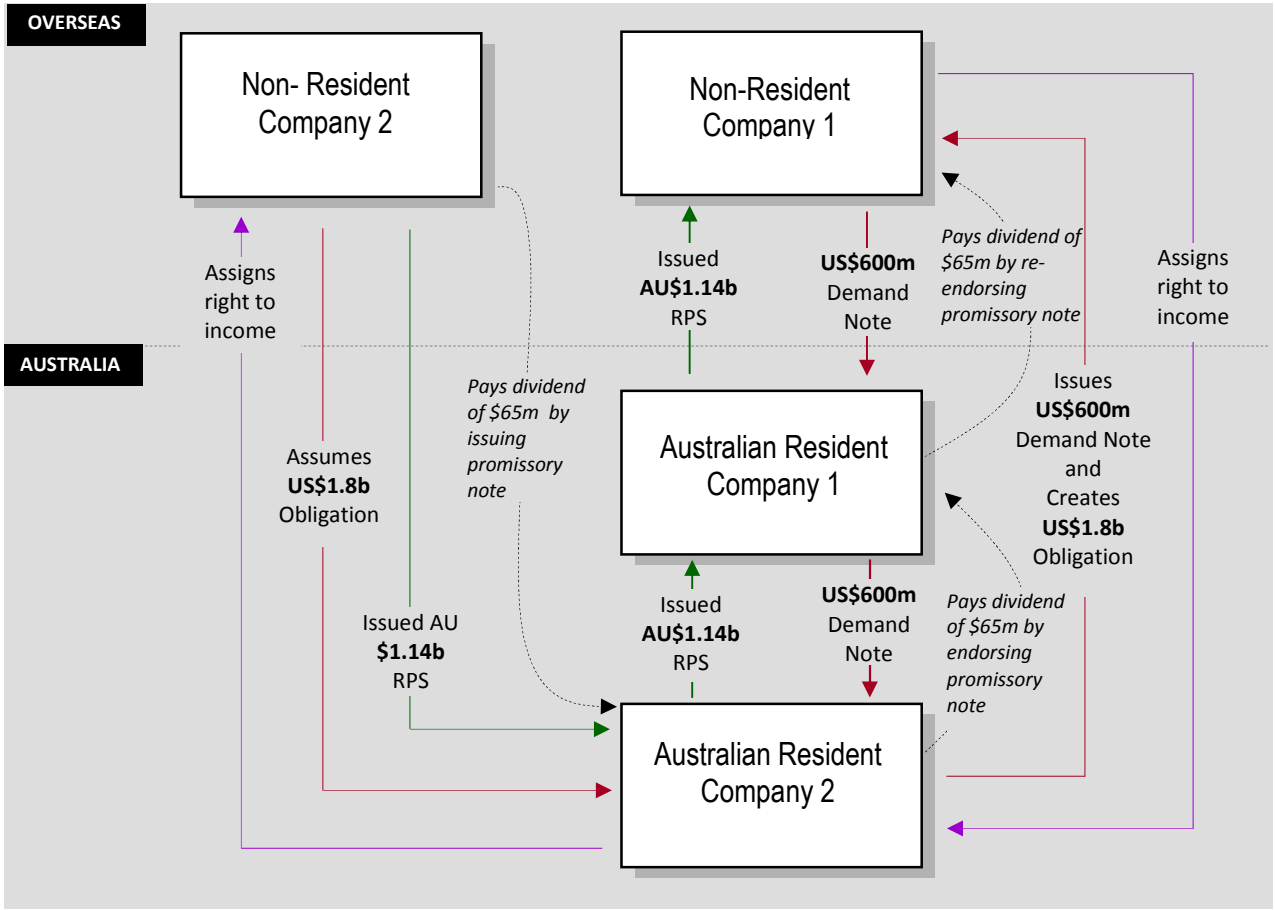
This is illustrated in the diagram below:



Example 2

1. The arrangement involves an intra-group transfer of an income stream from a non-resident entity to an Australian resident which in turn transfers it to another non-resident entity. Redeemable preference shares are issued by the related entities as part of the financing of the transfer of the income streams.
2. The obligations of the parties to pay dividends on the redeemable preference shares are satisfied by way of the initial issue and subsequent endorsement and re-endorsement of a promissory note. The dividend paid on the redeemable preference shares issued by the non-resident entity to the Australian resident is then returned to the Australian resident as non-assessable non-exempt income. This dividend is then on-paid by the Australian resident to another Australian resident and then ultimately to the original non-resident entity. This generates a deduction under section 25-90 of the ITAA 1997.

This is illustrated in the diagram below:



FEATURES WHICH CONCERN US

The ATO considers that arrangements substantially of this type give rise to taxation issues, including whether:

a. the arrangement or certain steps within it constitute a sham at general law;

b. any amount of income received by any entity involved in the arrangement is assessable to them under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);

c. any amount of income received by any entity involved in the arrangement is assessable to them under paragraph 44(1)(a) of the *Income Tax Assessment Act 1936* (ITAA 1936);

d. any income received or receivable is a non-portfolio dividend for the purposes of section 23AJ of the ITAA 1936;

e. any amount expended by the Australian resident entity would be deductible under section 8-1 of the ITAA 1997, including the extent to which such an amount was incurred in gaining or producing non-assessable non-exempt income;

f. any costs incurred on the borrowed funds are properly incurred under section 25-90 of the ITAA 1997 in deriving non-assessable non-exempt income;

g. any income derived by the non-resident entity should be attributable income of the Australian resident entity for the purposes of the CFC rules under Part X of the ITAA 1936;

h. any income derived by the non-resident entity should be attributed to the Australian resident entity as FIF income under Part XI of the ITAA 1936;

i. any transaction which forms part of the arrangement may be subject to the transfer pricing provisions contained in Division 13 of the ITAA 1936 (for example, the rate of interest payable on any loan);

j. any articles in applicable tax treaties between Australia and a relevant country may apply;

k. the general anti-avoidance rules contained in Part IVA of the ITAA 1936 apply to cancel any tax benefits under the arrangement; and

l. any entity involved in the arrangement may be a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to the *Taxation Administration Act 1953*.

The ATO is currently reviewing these arrangements. After considering two variations on such arrangements, the preliminary ATO view is that they are ineffective at law or that the general anti-avoidance provisions contained in Part IVA of ITAA 1936 apply to them.

***Note 1**: Base penalties of up to 50% of the tax avoided can apply where Part IVA is applied. Base penalties of up to 75% of the tax avoided can apply where you make a false and misleading statement to the Commissioner. Reductions in base penalty will be available if the taxpayer makes a voluntary disclosure to the ATO. If you have any information about the current arrangement, phone us on 1800 177 006. Tax agents wanting to provide information about people or companies who may be promoting arrangements covered by this alert should call the tax agent integrity service on 1800 639 745.*

***Note 2**: Penalties of up to 5,000 penalty units for individuals, 25,000 penalty units for bodies corporate or up to twice the amount of consideration received or receivable may apply to promoters of tax exploitation schemes under Division 290 of Schedule 1 to the Taxation Administration Act 1953. The Commissioner can also apply to the Federal Court of Australia for restraining and performance injunctions against promoters where prohibited conduct has occurred, is occurring or is proposed.*

Subject references:
Aggressive tax planning
Arrangement
Promoters

Legislative references:
Income Tax Assessment Act 1936
Part IVA
Part X
Part XI
Division 13
Section 23AJ
Section 44

Income Tax Assessment Act 1997
Section 6-5
Section 8-1
Section 25-90
Taxation Administration Act 1953
Schedule 1 Div 290

Related Rulings/Determinations
TD 2008/23
TD 2008/24
TD 2008/25

Related media releases:

File references:

Date issued:	**23 April 2009**
Authorised by:	**Stephanie Martin** Deputy Commissioner
Contact Officer:	**Paul Suppree**
Business Line:	**Large Business & International**
Section:	**Financial Services Industry Group**
Phone:	**(03) 9937 9242**