TA 2018/4 - Accrual deductions and deferral or avoidance of withholding tax

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Australian Government
Australian Taxation Office

Taxpayer Alert
TA 2018/4

Accrual deductions and deferral or avoidance of withholding tax

Alerts provide a summary of our concerns about new or emerging higher risk tax or superannuation arrangements or issues that we have under risk assessment.

While an Alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an Alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to PS LA 2008/15 *for more information about Alerts. See* Alerts *issued to date.*

Description

We are reviewing the implementation of a variety of cross-border arrangements where income tax deductions are claimed in Australia on an accruals basis under Division 230 of the *Income Tax Assessment Act 1997* (ITAA 1997)[1] but withholding tax is not paid when deductions are claimed.

Relevant arrangements typically display the following features:

(a) Funds are provided by a non-resident entity to a related[2] resident entity pursuant to a financial arrangement. The legal form of the arrangement may vary; to date, we have seen loans and redeemable preference shares.

(b) Funds provided are repayable at the end of the term of the financial arrangement, and a return is calculated on the funds provided.

(c) Entitlement to interest is deferred, including where it is payable at the end of the term of the financial arrangement.

(d) The way in which the arrangement is structured or carried out raises one of the concerns set out below.

What are our concerns?

We are concerned about:

- tax-driven structuring to produce a current deduction but deferral of withholding tax.
- claiming a deduction where payment is not expected to take place, or, when the return is paid, it is not expected to trigger a withholding tax liability.
- tax issues that arise from how the transaction is effected, including whether

[1] All legislative references are to the ITAA 1997 unless otherwise specified.
[2] For this purpose, a 'related entity' includes both an entity which is a 'connected entity' of the other entity, and, where the funds are provided by an entity other than a retail investor, there is any level of ownership between the entities, or by another party in each of the entities.

- a liability for withholding tax arises because interest, though not paid, is dealt with on behalf of the non-resident or as the non-resident directs[3]
- a loss is sufficiently certain under Division 230
- the arrangement is an equity interest under Division 974
- reassessment is triggered under Division 230
- a balancing adjustment arises under Division 230
- the commercial debt forgiveness provisions apply, or, where a forgiveness would give rise to ordinary income, subsection 230-15(1) applies[4]
- the anti-avoidance provisions apply
- the promoter penalty laws in Division 290 of Schedule 1 to the *Taxation Administration Act 1953* apply to promoters of this arrangement.

What arrangements are we not concerned with?

We are not concerned with the mere fact that a deduction is claimed on an accruals basis under Division 230 while the corresponding withholding tax liability arises on entitlement to interest. To be seen as low risk, the taxpayer should be able to convincingly demonstrate, with evidence, that deferral of the entitlement to interest is driven by commercial non-tax factors[5], and withholding tax is paid when the entitlement becomes due.

The more artificial the form of the instrument, and the less it reflects the natural commercial relationship between the parties, the more likely it is to be approached by us as high risk.

Tax issues

A taxpayer cannot claim deductions on an accruals basis under Subdivision 230-B if there is not a sufficiently certain loss within section 230-100. In deciding whether a loss is sufficiently certain, it is necessary to have regard to the commercial substance of the arrangement.[6] Furthermore, the accruals method does not apply if the arrangement is an equity interest.[7]

The return on the relevant arrangements may be capitalised or accrued. Liability for withholding tax will arise prior to actual payment where the interest is reinvested, accumulated, capitalised, carried to any reserve however designated, or otherwise dealt with on behalf of the non-resident or as the non-resident directs, under subsection 128A(2) of the ITAA 1936. There may be arrangements in which what is termed 'accrual' of interest has the same effect as capitalisation for the purposes of subsection 128A(2). The obligation to withhold arises when there is a withholding tax liability. Section 26-25 denies an accrual deduction if withholding tax has not been withheld and paid in these circumstances.

[3] In accordance with subsection 128A(2) of the *Income Tax Assessment Act 1936* (ITAA 1936).

4 Under paragraph 245-85(1)(a) the gross forgiven amount is reduced by the amount that would be assessable pursuant to section 6-5, so, if the net forgiven amount is nil, any gain from a financial arrangement (included in assessable income under subsection 230-15(1)) will not be reduced under paragraph 230-470(b).

[5] An example of this situation might be where finance was provided for a project that was not expected to generate revenue during a construction phase.

[6] See section 230-115.

[7] See paragraph 230-40(4)(e).

In some cases, key terms of the financial arrangement are subsequently varied. For example, the terms of a loan may be varied such that there is no obligation to repay the principal or the return, or the arrangement becomes an equity interest. This may indicate that the debt does not continue to exist, triggering the commercial debt forgiveness rules in Division 245 or giving rise to a gain (which has the character of income according to ordinary concepts) that is assessable under subsection 230-15(1). This feature may also indicate that a balancing adjustment has been triggered under section 230-435 or that a reassessment has been triggered under section 230-185.

In appropriate cases, Part IVA of the ITAA 1936 may apply, not limited to, but including, where there is a subsequent variation of the arrangement or the return is never paid.

Where the arrangement is varied, particularly in a way that has significant tax implications, we will review the arrangement and variation closely to determine whether that variation or similar was under serious contemplation from the commencement of the arrangement, and whether the arrangement should be treated from conception as incorporating the variation. In extreme cases, a subsequent 'variation' which was always intended to occur may not only go to the tax treatment of the arrangement, but also to whether the true arrangement has been obscured from the Commissioner.

What are we doing?

We are currently reviewing these arrangements and engaging with taxpayers who have entered into, or are considering entering into these arrangements. Compliance activity and engagement will continue and we are developing our technical position on the facts and circumstances of each arrangement.

Taxpayers and advisors who enter into these types of arrangements will be subject to increased scrutiny.

What should you do?

If you have entered, or are contemplating entering into, an arrangement of this type, we recommend you seek independent professional advice. We also encourage you to:

- discuss your situation with us by emailing Top1000program@ato.gov.au, or
- contact the officer named in this Alert.

Contact officer: **Karen Price**

Email address: **karen.price@ato.gov.au**

Telephone: **(02) 9374 1782**

Commissioner of Taxation
20 December 2018

References

ATOlaw topics	Income tax ~~ Commercial debt forgiveness ~~ Application of net forgiven amounts ~~ Deduction otherwise allowable Income tax ~~ Taxation of financial arrangemetns (TOFA) ~~ Balancing adjustment International ~~ Cross border financing ~~ Other
Legislative references	ITAA 1936 ITAA 1936 128A(2) ITAA 1936 Pt IVA ITAA 1997 ITAA 1997 6-5 ITAA 1997 26-25 ITAA 1997 Div 230 ITAA 1997 Subdiv 230-B ITAA 1997 230-15(1) ITAA 1997 230-40(4)(e) ITAA 1997 230-100 ITAA 1997 230-115 ITAA 1997 230-185 ITAA 1997 230-435 ITAA 1997 230-470(b) ITAA 1997 Div 245 ITAA 1997 245-85(1)(a) ITAA 1997 Div 974 TAA 1953 TAA 1953 Div 290 Sch 1
Related practice statements	PS LA 2008/15
Authorised by	Jeremy Hirschhorn, Deputy Commissioner Public Groups and International

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