



TD 2009/1 - Income tax: does subsection 974-135(1) of the Income Tax Assessment Act 1997 only apply to a legally enforceable obligation?

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Taxation Determination

Income tax: does subsection 974-135(1) of the *Income Tax Assessment Act 1997* only apply to a legally enforceable obligation?

❶ This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant 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.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

Ruling

1. No. Under subsection 974-135(1) of the *Income Tax Assessment Act 1997* (ITAA 1997),¹ there will be an 'effectively non-contingent obligation' to take an action under a scheme if, 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. An 'obligation' for the purposes of this provision does not have to be a legally enforceable obligation.
2. The clause 'there is in substance or effect a non-contingent obligation' in subsection 974-135(1) is to be interpreted as 'there is in substance or effect an obligation that is, in substance or effect, non-contingent'.

¹ All subsequent legislative references are to the ITAA 1997 unless otherwise indicated.

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Date of effect

3. This Determination applies to years of income commencing both before and after its date of issue. However, this Determination will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Determination (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation

14 January 2009

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

Explanation

4. Division 974 of the ITAA 1997 was introduced by the *New Business Tax System (Debt and Equity) Act 2001* (the Debt Equity Act). One of the objects of Division 974 of the ITAA 1997 is to establish a test to determine whether a scheme gives rise to a debt interest or an equity interest for certain taxation purposes. The major consequences that follow classification as a debt or equity interest are that returns paid on a debt interest may be deductible, but will not be frankable, while returns paid on an equity interest will be frankable but not deductible.

5. The test is to operate with regard to the economic substance of the rights and obligations under the scheme rather than the mere legal form of the arrangements (subsection 974-10(2)).

6. The test for a debt interest is in Subdivision 974-B. The term 'effectively non-contingent obligation' is used for several purposes in the debt test.

7. The meaning of 'effectively non-contingent obligation' is given by section 974-135.² Subsection 974-135(1) provides as follows:

There is an 'effectively non-contingent obligation' to take an action under a scheme if, having regard to the pricing, terms and conditions of the scheme, there is in substance or effect a non-contingent obligation (see subsections (3), (4) and (6)) to take that action.

8. Subsection 974-135(1) is concerned with an effectively non-contingent obligation 'to take an action' (see also subsection 974-135(2)). The debt test in Subdivision 974-B contains provisions that refer to effectively non-contingent obligations to take the following actions:

- (a) provide a financial benefit (paragraph 974-20(1)(c));
- (b) terminate an interest within 10 years of issue, even if the terms of issue of the interest formally allow an obligation to take some other action under the scheme to continue beyond 10 years (subsection 974-35(4)); and
- (c) exercise a right or option to terminate a scheme early (subsection 974-40(2)).

9. Subsection 974-135(1) requires that a 'non-contingent obligation' is to be found as a matter of 'substance or effect' and, for that purpose, regard is to be had to the 'pricing, terms and conditions of the scheme'.

10. The use of the word 'obligation' in defining the meaning of 'effectively non-contingent obligation' and the regard that is to be had to the 'terms and conditions' of the scheme under which that obligation arises might be taken to suggest that the 'obligation' must be a legally enforceable obligation. However, the reference in subsection 974-135(1) to whether there is 'in substance or effect' a non-contingent obligation to take the relevant action can be taken as requiring an enquiry that is to extend beyond consideration of whether there is only a legally enforceable obligation to take that action.

² Subsection 995-1(1).

11. The Commissioner considers that the more natural reading of the subsection is that the provision is concerned with finding (under a scheme) a 'non-contingent obligation' that is evident 'in substance or effect', and does not require that there only be legally enforceable obligations. However, the Commissioner acknowledges that there could be some concern that the words 'in substance or effect' are intended to qualify only the word 'non-contingent', rather than both of the words 'non-contingent' and 'obligation'. That is, if the former is intended, the provision is to be read as applying to an obligation that is in substance or effect non-contingent. However, if the latter is intended, the provision is concerned with whether there is in substance or effect an obligation that is in substance or effect non-contingent. An obligation that exists as a matter of substance or effect might not be legally enforceable. In so far as there is any ambiguity, it is appropriate to refer to relevant material that is extrinsic to the Debt Equity Act to determine the meaning of the provision: section 15AB of the *Acts Interpretation Act 1901*.

12. The reasons for adopting the concept of an effectively non-contingent obligation are discussed in paragraphs 2.174 and 2.175 of the Explanatory Memorandum (the EM) to the New Business Tax System (Debt and Equity) Bill 2001 (the Debt Equity Bill) in the context of an effectively non-contingent obligation 'to provide a financial benefit':

2.174 Debt in a formal sense involves obligations which are non-contingent in legal form (e.g. a legal obligation to pay interest and to return principal). However, if the debt test were to focus solely on obligations which are non-contingent in legal form, schemes that are equivalent in economic substance might give rise to different tax outcomes. This would encourage tax arbitrage and open up tax avoidance opportunities.

2.175 The debt test therefore uses the concept of an *effectively* non-contingent obligation as opposed to a *legally* (or formally) non-contingent obligation. Thus a scheme under which an entity **has a right but not a legal obligation to provide a financial benefit could nevertheless be debt if, having regard to the pricing, terms and conditions of the scheme, the entity is in substance or effect inevitably bound, to exercise that right.** This would occur where not to exercise the right would result in the entity having to sustain a greater loss (in present value terms) from the scheme than if it exercised the right. A simple example of this would be where the issuer of a financing instrument has a right to redeem it after a certain period but is compelled to provide accelerating returns on the instrument if it does not exercise that right: the accelerating returns would make it uneconomic for the issuer not to redeem the instrument so that it is under an effectively non-contingent obligation to do so.

(Emphasis added)

13. Paragraph 2.175 of the EM to the Debt Equity Bill clearly indicates that it is intended that an effectively non-contingent obligation to provide a financial benefit can be found where a party has a **right** that it may exercise to provide a financial benefit where it does not have a legal obligation in form to take that action. This will occur if, after considering the pricing, terms and conditions of the scheme, the party is in substance or effect inevitably bound to exercise that right.

14. The use of 'effectively non-contingent obligation' in other provisions in Division 974 also confirms that the term is not confined to legally enforceable obligations. Subsections 974-35(4) and 974-40(2), as noted at paragraph 8 of this Determination, both refer to circumstances where a party has an 'effectively non-contingent obligation' to take an action. Both subsections apparently contemplate the existence of an effectively non-contingent obligation to take the applicable action in circumstances where there is a right or option but not a legally enforceable obligation to take that action.

15. In addition, a 'scheme' is broadly defined in subsection 995-1(1) and includes an arrangement. 'Arrangement' as defined in subsection 995-1(1) includes agreements and similar '...whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings'. It would be inconsistent with the broad definition of a scheme under which an effectively non-contingent obligation to take an action may be found if only legally enforceable obligations could be relevant 'obligations'.

16. The words 'in substance or effect a non-contingent obligation' are therefore not only intended to apply in circumstances where there is an obligation in legal form.

17. The Commissioner considers that the words 'in substance or effect' refer to both the contingency and the obligation. That is, the Commissioner considers that the words 'in substance or effect a non-contingent obligation' in subsection 974-135(1) are intended to be interpreted as 'in substance or effect an obligation that is, in substance or effect, non-contingent'.

18. It will of course often be the case that there is a legal obligation under a contract to take the relevant action, and that the legal obligation will be an effectively non-contingent obligation under a scheme. The Supplementary Explanatory Memorandum and Correction to the Explanatory Memorandum to the Debt Equity Bill noted as follows at paragraphs 1.9 and 1.10:

1.9 These amendments highlight that the test of whether a scheme or schemes give rise to either a debt interest or an equity interest is not to be approached by focusing on their mere legal form at the expense of the economic substance of the rights and obligations in respect of the scheme or schemes.

1.10 This is not to say that the form of the particular interest is to be ignored; often the form is consistent with, and indicates, what the substance is.

19. The EM to the Debt Equity Bill also noted as follows at paragraph 2.176:

2.176 The concept of an effectively non-contingent obligation is, however, not intended to displace regard to legal rights and obligations. This is particularly so where those rights and obligations are consistent with arm's length transactions of commercial substance and reflect the clear intention of the parties.

References

Previous draft:

TD 2008/D14

Related Rulings/Determinations:

TR 2006/10

Subject references:

- debt equity borderline
- effectively non-contingent obligation

Legislative references:

- TAA 1953
- ITAA 1997
- ITAA 1997 Div 974
- ITAA 1997 974-10(2)
- ITAA 1997 Subdiv 974-B
- ITAA 1997 974-20(1)(c)
- ITAA 1997 974-35(4)

- ITAA 1997 974-40(2)
- ITAA 1997 974-135
- ITAA 1997 974-135(1)
- ITAA 1997 974-135(2)
- ITAA 1997 995-1(1)
- Acts Interpretation Act 1901 15AB
- New Business Tax System (Debt and Equity) Act 2001

Other references:

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

ATO references

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