TD 2015/10 - Income tax: will paragraph 974-80(1)(d) of the Income Tax Assessment Act 1997 be satisfied merely because a company has issued a debt interest to a listed property trust within the same stapled property group?

There is a Compendium for this document: **TD 2015/10EC** .

Taxation Determination

Income tax: will paragraph 974-80(1)(d) of the *Income Tax Assessment Act 1997* be satisfied merely because a company has issued a debt interest to a listed property trust within the same stapled property group?

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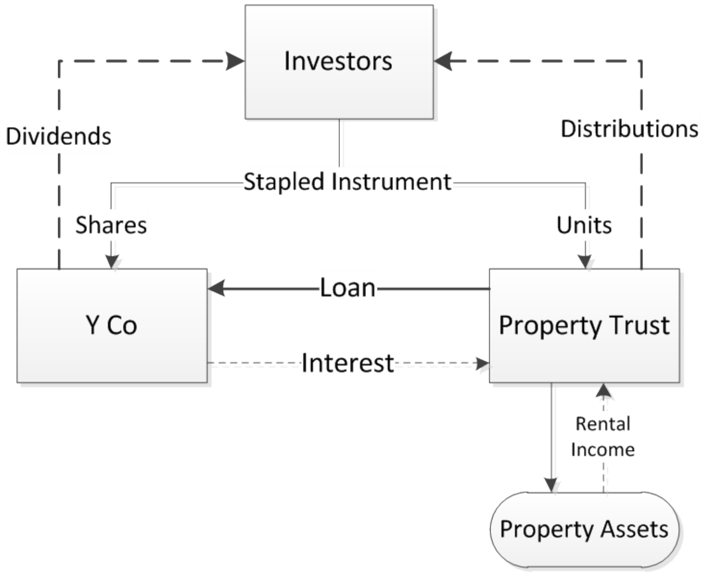
Ruling

1. No. The fact that a company has issued a debt interest to a listed property trust within the same stapled property group 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 what is in substance equity held by another person (the 'ultimate recipient').

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

Example 1



2. *Property Trust is a listed property trust. It holds Australian commercial properties with a total market value of $500 million. It derives rental income from leasing these properties to third parties.*

3. *Property Trust is not taxed under Division 6C of Part III to the Income Tax Assessment Act 1936.*

4. *Y Co is a company. Its activities mainly comprise property development and management of the properties owned by Property Trust. Property Trust pays to Y Co a monthly fee for the management services (at market rate). It is assumed, for the purposes of this example, that Property Trust is a 'connected entity' of Y Co as defined in subsection 995-1(1).*

5. *Property Trust and Y Co enter into a Stapling Deed. Under the Stapling Deed, each unit in Property Trust is stapled to a share in Y Co and cannot be traded separately. The stapled securities are then offered to the investors by way of a prospectus.*

6. *A total of $50 million is raised on the issue of stapled securities. The funds raised are allocated to Y Co and Property Trust having regard to the relative net asset value of the two entities - $30 million is contributed to Property Trust and $20 million to Y Co.*

7. *Property Trust lends its $30 million to Y Co for use in Y Co's business. The loan has a term of 9 years, and is interest bearing. Unpaid interest accrues and is payable together with any principal at the end of the loan term.*

8. The loan from Property Trust to Y Co is a debt interest under subsection 974-15(1). The shares in Y Co are equity interests under subsection 974-70(1). The units in Property Trust are neither debt nor equity interests under Division 974 although they are equity interests under section 820-930.

9. In respect of the loan from Property Trust to Y Co:

(a) paragraph 974-80(1)(a) is satisfied because the loan carries a right to a variable or fixed return from Y Co

(b) paragraph 974-80(1)(b) is satisfied because the loan is an interest held by Property Trust, a connected entity of Y Co

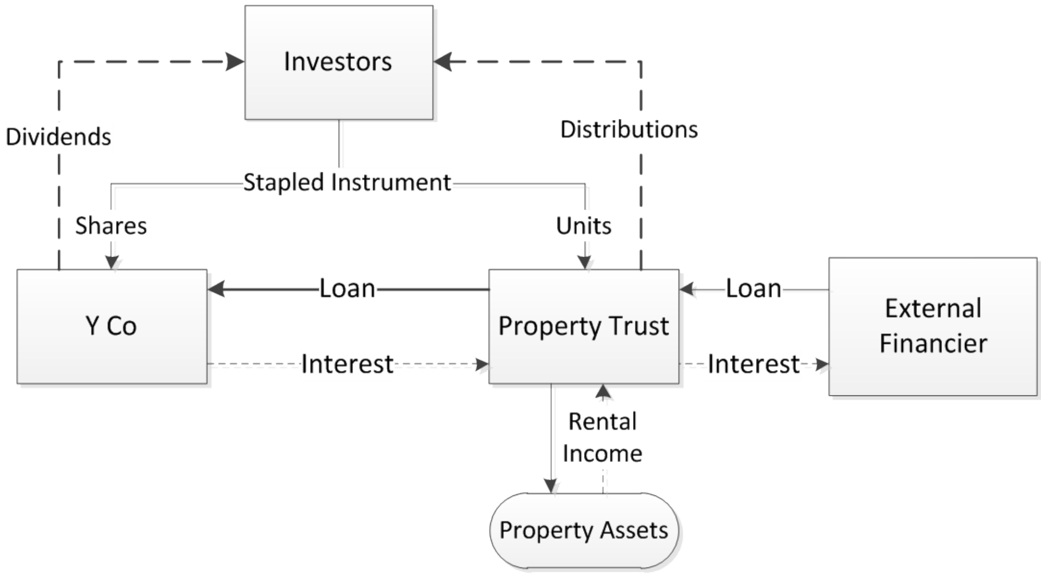
(c) paragraph 974-80(1)(c) is satisfied because apart from section 974-80, the loan would not be an equity interest in the company

(d) paragraph 974-80(1)(ca) is satisfied because the scheme that gives rise to the loan is a financing arrangement for Y Co.

10. However, paragraph 974-80(1)(d) will not be satisfied. The fact that Y Co has issued a debt interest to Property Trust will not on its own be sufficient to conclude that the scheme or series of schemes is designed to operate so that the interest on the loan is used to fund (directly or indirectly) a return to the stapled security holders. To satisfy paragraph 974-80(1)(d), a stronger connection between the interest on the loan and the trust distributions must be evident from the structure of the scheme or series of schemes, such that it is reasonable to conclude that the Property Trust's distributions to the stapled security holders are indirectly a return from Y Co. Relevant connections could include that Y Co was almost exclusively funded by the loan from Property Trust and/or the return on the loan was designed to pass the vast majority of Y Co's profits to Property Trust.

11. Similarly, paragraph 974-80(1)(d) would not be satisfied if all other facts in this example were the same but Property Trust and Y Co were an existing stapled group, and the stapled securities were issued by way of an additional capital raising for the stapled group.

Example 2



12. *Assume that instead of issuing new stapled securities and on-lending its share of the funds raised by the issue, Property Trust in Example 1 borrows $50 million from an external financier. The loan has a term of 7 years, and is interest bearing. Unpaid interest accrues and is payable together with any principal at the end of the loan term. Property Trust on-lends the $50 million borrowed to Y Co, at a mark up on the interest rate on the loan from the external financier.*

13. As in Example 1, the loan from Property Trust to Y Co is a debt interest under subsection 974-15(1). The shares in Y Co are equity interests under subsection 974-70(1). The units in Property Trust are neither debt nor equity interests under Division 974 although they are equity interests under section 820-930. In respect of the loan from Property Trust to Y Co, paragraphs 974-80(1)(a), 974-80(1)(b), 974-80(1)(c) and 974-80(1)(ca) are satisfied.

14. However, paragraph 974-80(1)(d) will not be satisfied. The fact that Y Co has issued a debt interest to Property Trust will not on its own be sufficient to conclude that the scheme or series of schemes are designed to operate so that the interest on the loan from Property Trust to Y Co is used to fund (directly or indirectly) a return to the stapled security holders. To satisfy paragraph 974-80(1)(d), a stronger connection between the interest on the loan and the trust distributions must be evident from the structure of the scheme or series of schemes, such that it is reasonable to conclude that the Property Trust's distributions to the stapled security holders are indirectly a return from Y Co.

Date of effect

15. 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
22 April 2015

Appendix 1 – Explanation

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

16. A common business structure in the Australian property sector is that of a stapled group (property stapled group). Generally, this business structure combines a listed property trust (LPT) with a property management and development company (PMC). The LPT owns a portfolio of properties while the PMC manages and may also develop the properties. The shares in the PMC are stapled to the units in the LPT. While the securities are on issue they cannot be sold or otherwise dealt with separately. The stapled securities can be traded on the Australian Stock Exchange.

17. The commercial rationale for using a stapled structure in the property sector is that it enables investors to have direct exposure to the passive assets as well as an interest in the income from the management of those assets. The investors receive both dividends (with any franking credits attached) from the company and pre-tax distributions from the LPT. Tax preferences, such as capital allowances, to which the trustee is entitled, flow through to the investors.

18. There may be instances where the LPT uses its surplus funds to acquire a debt interest from the PMC. In such instances, the question arises whether section 974-80 in Division 974[2] applies to re-characterise the debt interest as an equity interest.

19. Section 974-80 is a specific rule within Division 974 which 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 equity-like returns to the ultimate recipient are funded from otherwise tax deductible payments made by the company.[3] 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.[4]

20. 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 return from the company: paragraph 974-80(1)(a). Secondly, that interest must be held by a connected entity[5] of the company: paragraph 974-80(1)(b). Thirdly, the interest must not otherwise be an equity interest in the company: paragraph 974-80(1)(c). Fourthly, the scheme that gives rise to the interest must be a financing arrangement[6] for the company: 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*).

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[2] Division 974 contains rules for classifying an interest as debt or equity for certain tax purposes.
[3] 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.
[4] 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.

[5] 'Connected entity' is defined in section 995-1.
[6] 'Financing arrangement' is defined in section 974-130.

21. It has been argued that the test in paragraph 974-80(1)(d) will be satisfied in all cases where the PMC has issued a debt interest to an LPT within the same stapled group. In other words, it is argued that, in all cases where the PMC pays a return on a debt interest to the LPT within the same stapled group which then makes distributions to the stapled group investors, 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 in substance equity returns to the stapled group investors.

22. The Commissioner does not agree with the argument. The Commissioner considers that paragraph 974-80(1)(d) will only 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 equity returns from the company, albeit indirectly.

23. Paragraph 974-80(1)(d) will not be satisfied merely because the arrangement results in the return on the debt interest paid by the PMC to the LPT being a potential source of funds which fund the LPT distributions to the stapled group investors.

24. Absent evidence suggesting otherwise, the return on the debt interest paid by the PMC is merely *a* source of funds which will potentially be used by the LPT to fund distributions to the stapled group investors. In these circumstances, it would not be reasonable to conclude that the stapled group investor is in-substance receiving equity returns from the PMC and thus there would not be a scheme, or series of schemes, under which returns paid by the PMC to the LPT in the stapled group were designed to fund returns on equity interests held by the stapled group investors.

References

Previous draft:

TD 2014/D20

Related Rulings/Determinations:

TR 2006/10

Subject references:

- debt interest
- equity test
- stapled companies
- stapled structure

Legislative references:

- ITAA 1936 Pt III Div 6C
- ITAA 1997
- ITAA 1997 26-26
- ITAA 1997 820-930
- ITAA 1997 Div 974
- ITAA 1997 974-15(1)
- ITAA 1997 974-70(1)
- 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)
- TAA 1953

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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