

TD 2015/2 - 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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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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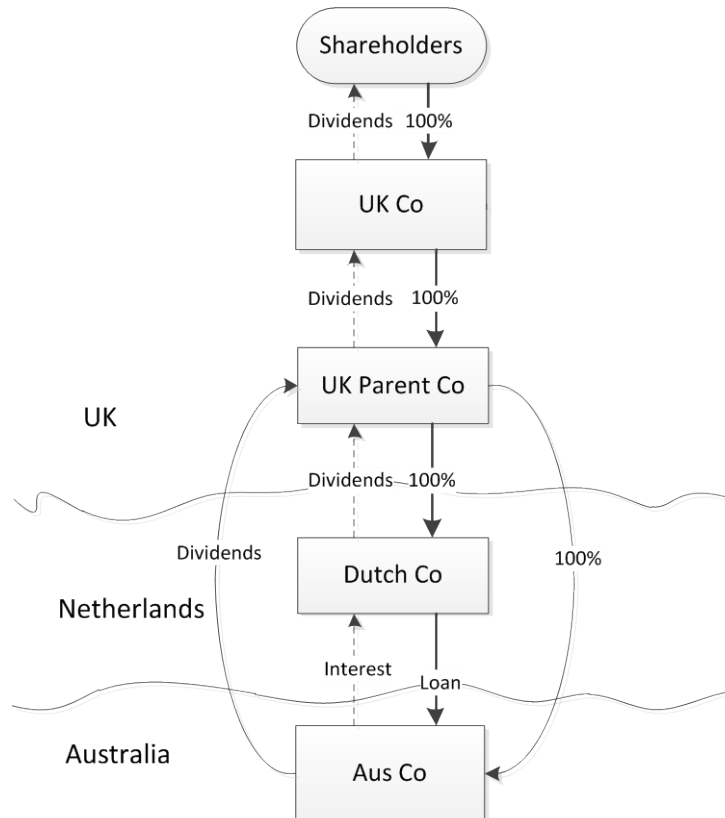
Ruling

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 what is in substance equity held by another person (the 'ultimate recipient').

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

Examples

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

**Example 1**

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 a number of other group entities, including Aus Co.
6. UK Co has decided that the group will acquire a new business in Australia and has determined that the business will be held by Aus Co. In order to finance the acquisition, Aus Co requires \$300 million.
7. UK Co directs UK Parent Co to incorporate a special purpose company in the Netherlands, Dutch Co.
8. UK Parent Co contributes \$300 million to acquire all the issued shares in Dutch Co.
9. Dutch Co uses the funds contributed by UK Parent Co to make a loan with interest to Aus Co for a 9.5 year term.
10. UK Co, UK Parent Co and Dutch Co are connected entities of Aus Co as defined in subsection 995-1(1).
11. Aus Co incurs interest to Dutch Co pursuant to the loan agreement between Dutch Co and Aus Co.

12. *Dutch Co in turn pays dividends to UK Parent Co.*
13. *UK Parent Co pays dividends to UK Co out of a pool of dividends received from subsidiaries, including Dutch Co.*
14. *UK Co pays dividends to its shareholders.*
15. *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 (which in turn pays dividends to its 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 Co's shareholders. In order for paragraph 974-80(1)(d) to be satisfied there must be a stronger connection between the payments of interest by Aus Co and payment of dividends to shareholders in UK Co 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.²*

Example 2

16. *In Example 1, assume that instead of investing in the existing Australian subsidiary of the group, Dutch Co acquires a new Australian resident subsidiary, Aus Co, by acquiring all the shares in Aus Co for \$150 million as well as acquiring a new debt interest in Aus Co for \$150 million.*
17. *For the reasons given in Example 1, paragraph 974-80(1)(d) will not be satisfied.*

Date of effect

18. 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 Taxation18 March 2015

² On the facts in the Example the 'ultimate recipient' within the meaning of paragraph 974-80(1)(d) is the shareholders of UK Co. However, this won't be the case in respect of every scheme or series of schemes involving a chain of entities. Whether the 'ultimate recipient' is an entity with an interest in the head entity or an entity further down the chain will depend on the facts and circumstances of a particular scheme or series of schemes.

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.*

19. 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.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 rate of return: paragraph 974-80(1)(a). Secondly, that interest must be held by a connected entity⁵ 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:⁶ 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*).

21. It has been argued that the test in paragraph 974-80(1)(d) will 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.

22. 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.

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.

23. 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.

24. 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 interest were designed to be the source of funds to fund returns on the equity interests held by the ultimate recipients.

References

Previous draft:

TD 2014/D18

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)
- 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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