TD 2016/6 - Income tax: is an amount that is a cost in relation to a debt interest covered by paragraph 820-40(1)(a) of the Income Tax Assessment Act 1997 (ITAA 1997) deductible under section 25-90 of the ITAA 1997 (or, alternatively, under subsection 230-15(3) of the ITAA 1997) where that amount is incurred in earning income that meets the requirements of both section 23AH of the Income Tax Assessment Act 1936 and section 768-5 of the ITAA 1997?

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There is a Compendium for this document: **TD 2016/6EC** .

Taxation Determination

Income tax: is an amount that is a cost in relation to a debt interest covered by paragraph 820-40(1)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997) deductible under section 25-90 of the ITAA 1997 (or, alternatively, under subsection 230-15(3) of the ITAA 1997) where that amount is incurred in earning income that meets the requirements of both section 23AH of the *Income Tax Assessment Act 1936* and section 768-5 of the ITAA 1997?

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Ruling

1. No. Income that meets the requirements of both section 23AH of the *Income Tax Assessment Act 1936* (ITAA 1936) and section 768-5 of the ITAA 1997 is not 'non-assessable non-exempt income *under* section 768-5 [of the ITAA 1997]' for the purposes of section 25-90 of the ITAA 1997.

2. Accordingly, where an amount is incurred and that amount is a cost in relation to a debt interest that is covered by paragraph 820-40(1)(a) of the ITAA 1997, the amount is not deductible under section 25-90 of the ITAA 1997 where the amount is incurred in earning income that meets the requirements of both section 23AH of the ITAA 1936 and section 768-5 of the ITAA 1997.

3. Where Division 230 of the ITAA 1997 applies to a financial arrangement of an entity, the counterpart of section 25-90 of the ITAA 1997, subsection 230-15(3) of the ITAA 1997, has operation instead of section 25-90 of the ITAA 1997. Thus, where a taxpayer makes a loss from the financial arrangement, it will not be deductible under subsection 230-15(3) of the ITAA 1997 where the income meets the requirements of both section 23AH of the ITAA 1936 and section 768-5 of the ITAA 1997.

Example

4. *An Australian resident bank (the Bank) carries on business and derives income at its branch in the United Kingdom (the UK Branch). Division 230 of the ITAA 1997 applies to the Bank's financial arrangements.*

5. *The Bank issues debentures to third party lenders to fund the acquisition of 40% of the shares in a UK resident company (the Company). This is a transaction which is undertaken in the ordinary course of the UK Branch's business. The Bank incurs interest in respect of this borrowing and is paid dividends by the Company.*

6. *The dividends constitute foreign branch income and are non-assessable non-exempt income pursuant to subsection 23AH(2) of the ITAA 1936. The dividends also qualify as foreign equity distributions and are non-assessable non-exempt income pursuant to section 768-5 of the ITAA 1997.*

7. *The income is not 'non-assessable non-exempt income* under *section 768-5 [of the ITAA 1997]' for the purposes of paragraph 230-15(3)(c); therefore, the interest incurred on the debentures is not deductible to the Bank under subsection 230-15(3).*

Date of effect

8. This Determination applies to amounts incurred in income years commencing after 30 June 2015. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
13 April 2016

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.

9. Section 25-90 of the ITAA 1997 provides that:

> An *Australian entity can deduct an amount of loss or outgoing from its assessable income for an income year if:
>
> (a) the amount is incurred by the entity in deriving income from a foreign source; and
>
> (b) the income is *non-assessable non-exempt income under section 768-5, or section 23AI or 23AK of the *Income Tax Assessment Act 1936*; and
>
> (c) the amount is a cost in relation to a *debt interest issued by the entity that is covered by paragraph (1)(a) of the definition of debt deduction.[1]

10. Where Division 230 of the ITAA 1997 applies to a financial arrangement of an entity, subsection 230-15(3) of the ITAA 1997 applies instead of section 25-90 of the ITAA 1997. It provides that:

> You can also deduct a loss you make from a *financial arrangement if:
>
> (a) you are an *Australian entity; and
>
> (b) you make the loss in deriving income from a foreign source; and
>
> (c) the income is *non-assessable non-exempt income under section 768-5, or section 23AI or 23AK of the *Income Tax Assessment Act 1936*; and
>
> (d) the loss is, in whole or in part, a cost in relation to a *debt interest you issue that is covered by paragraph 820-40(1)(a).

11. The Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008, which introduced Division 230 of the ITAA 1997, explained that subsection 230-15(3) of the ITAA 1997 was intended to apply in the same way as section 25-90 of the ITAA 1997.[2] The interpretation of the scope and operation of section 25-90 in this Determination will therefore be equally applicable to subsection 230-15(3).

12. Section 768-5 of the ITAA 1997 provides that certain foreign equity distributions[3] paid, directly or indirectly, to an Australian resident corporate tax entity[4] by a foreign company are non-assessable non-exempt income in the hands of the Australian corporate tax entity.

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[1] The definition of 'debt deduction' is contained in section 820-40 of the ITAA 1997.
[2] See paragraph 3.78 of the Explanatory Memorandum to the Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008.
[3] These are foreign equity distributions received from a foreign company in which the corporate tax entity holds an interest or interests of at least 10% under the participation test set out in section 768-15 of the ITAA 1997.
[4] 'Corporate tax entity' is defined in section 960-115 of the ITAA 1997 to include a company.

13. Broadly, section 23AH of the ITAA 1936 treats foreign income derived by an Australian resident company in carrying on a business at or through a permanent establishment of the company in a foreign country as non-assessable non-exempt income.[5] It provides similar rules for certain foreign branch capital gains, and also contains rules to ensure that foreign branch capital losses are not taken into account by the Australian resident company. A deduction is not allowable for costs incurred in deriving income that is non-assessable non-exempt under section 23AH.[6]

14. Where a foreign equity distribution is paid by a foreign company to an Australian resident company in respect of interests held by the Australian resident company in the ordinary course of the business conducted at or through its foreign branch, section 768-5 of the ITAA 1997 and section 23AH of the ITAA 1936 will apply concurrently to that income.

15. In such circumstances, it may initially appear that a deduction will be allowable under section 25-90 of the ITAA 1997 because an amount is incurred in deriving income that is non-assessable non-exempt income by the operation of section 768-5 of the ITAA 1997, even though the income is also non-assessable non-exempt pursuant to the concurrent operation of section 23AH of the ITAA 1936.

16. However, such a view fails to consider the meaning of the words used in section 25-90 of the ITAA 1997 in light of the purpose of the provision. Recent High Court authority has emphasised that the text of a statute must be considered in its context. In *Federal Commissioner of Taxation v. Consolidated Media Holdings Ltd* (2012) 250 CLR 503; [2012] HCA 55; 2012 ATC 20-361; (2012) 84 ATR 1 (*Consolidated Media Holdings*), the Full High Court stated that, although '[l]egislative history and extrinsic materials cannot displace the meaning of the statutory text'[7], they are part of the context in which the statutory text must be considered:

> 'This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the [statutory] text'. So must the task of statutory construction end. The statutory text must be considered in its context. That context includes legislative history and extrinsic materials. Understanding context has utility if, and in so far as, it assists in fixing the meaning of the statutory text. Legislative history and extrinsic materials cannot displace the meaning of the statutory text. Nor is their examination an end in itself.[8]

17. In *CIC Insurance Ltd v. Bankstown Football Club Ltd* 141 ALR 618; (1997) 187 CLR 384; [1997] HCA 2 (*CIC Insurance*), the majority of the High Court discussed the modern approach to the use of context in statutory interpretation, stating that:

> the modern approach to statutory interpretation (a) insists that the context be considered in the first instance, not merely at some later stage when ambiguity might be thought to arise, and (b) uses 'context' in its widest sense to include such things as the existing state of the law and the mischief which, by legitimate means such as those just mentioned, one may discern the statute was intended to remedy.[9]

18. Their Honours stated that 'if the apparently plain words of a provision are read in the light of the mischief which the statute was designed to overcome and of the objects of the legislation, they may wear a very different appearance.'[10]

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[5] Subsection 23AH(2) of the ITAA 1936. 'Foreign income' in section 23AH of the ITAA 1936 is defined in subsection 23AH(15) based on the definition of 'foreign income' in subsection 6AB(1) of the ITAA 1936, which states that 'foreign income' is 'income…derived from sources in a foreign country or foreign countries'. This definition is discussed in Taxation Ruling TR 2005/2 *Income tax: the meaning of 'foreign income' in subsection 6AB(1) of the Income Tax Assessment Act 1936 - inclusion of statutory income.*
[6] Subsection 8-1(2) of the ITAA 1997.
[7] *Consolidated Media Holdings* at [39].
[8] *Consolidated Media Holdings* at [39].
[9] *CIC Insurance* at CLR 408.
[10] *CIC Insurance* at CLR 408.

19. The meaning of the word 'under' in section 25-90 of the ITAA 1997 must be determined by reference to the statutory context in which it appears and in light of the mischief that the provisions were intended to overcome. This approach accords with the observations of Lindgren J in *Energy Resources of Australia Ltd v. Commissioner of Taxation* [2003] FCA 26; 2003 ATC 4024; (2003) 52 ATR 120 (*Energy Resources of Australia*), in which he noted that the word 'under' may have a wide range of meanings depending on the context in which it is used. His Honour stated:

> It is necessary to have regard to the context in order to identify the meaning of the word ['under'] intended in a particular case... The word 'under' admits of degrees of precision and exactness on the one hand, and of looseness and inexactness on the other.[11]

20. In *R v. Young* (1999) 46 NSWLR 681; [1999] NSWCCA 166, Spigelman CJ states:

> In order to construe the words actually used by parliaments, it is sometimes necessary to give them an effect as if they contained additional words. This is not, however, to introduce words into the Act. This involves the construction of the words actually used.[12]

21. The meaning of the word 'under' as used in section 25-90 of the ITAA 1997 must therefore be determined based on the statutory context.

Context

Availability of deductions and relationship with thin capitalisation rules

22. Prior to the enactment of the thin capitalisation regime in Division 820 of the ITAA 1997, borrowing costs incurred in funding foreign non-portfolio equity investments were subject to the general deductions provision in section 8-1 of the ITAA 1997.[13] Relevantly, subsection 8-1(2) denies deductions for the costs incurred in deriving non-assessable non-exempt income. The borrowing costs incurred by an Australian resident taxpayer in funding a foreign non-portfolio equity investment were therefore not deductible to the taxpayer.

23. Section 25-90 of the ITAA 1997 was enacted with the thin capitalisation rules in Division 820 of the ITAA 1997 and is referred to as a 'consequential amendment' to those rules, both within the amending legislation itself[14] and in the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.[15] Section 25-90 provides an exception to the general rule that losses or outgoings incurred in deriving non-assessable non-exempt income are not deductible. The section allows a deduction for 'debt deductions' incurred in deriving certain non-assessable non-exempt income.[16]

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[11] *Energy Resources of Australia* at [37].
[12] *R v. Young* (1999) 46 NSWLR 681; [1999] NSWCCA 166 at [6].
[13] There were also provisions that quarantined certain types of deductions in respect of foreign income, see paragraphs 3.3 and 3.4 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 and paragraph 9 of TD 2009/21.
[14] See the heading on page 126 of the *New Business Tax System (Thin Capitalisation) Act 2001*.
[15] See paragraphs 1.99 to 1.101 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.
[16] This observation was made at first instance by Gordon J in *Noza Holdings Pty Ltd v. Commissioner of Taxation* [2011] FCA 46; 2011 ATC 20-241; (2011) 82 ATR 338 at [156]; and Her Honour's observation was cited with approval by the Full Federal Court in *Federal Commissioner of Taxation v. Noza Holdings Pty Ltd* (2012) 201 FCR 445; [2012] FCAFC 43; 2012 ATC 20-313; (2012) 82 ATR 567 at [41].

24. Division 820 of the ITAA 1997, on the other hand, limits the debt deductions available to an Australian entity when that entity's amount of debt exceeds the maximum allowable debt. By imposing a limit pursuant to Division 820 on the amount of the debt costs that could be deducted, it was consequentially possible to remove, in part, the limitations then imposed on the availability of those deductions by section 8-1 of the ITAA 1997.[17]

Thin capitalisation and foreign branch income

25. In introducing Division 820 of the ITAA 1997 and section 25-90 of the ITAA 1997, the general approach adopted was to limit debt deductions based on the overall debt levels (or equity capital) of an entity's Australian operations rather than by the use to which the funds were put.[18]

26. The thin capitalisation rules were only intended to limit the debt deductions available to an Australian entity in respect of its Australian operations.[19] As a consequence, Division 820 of the ITAA 1997 does not impose limits on debt deductions to the extent that the cost is attributable to an overseas permanent establishment of an outward investing entity (including banks).[20] This includes debt deductions incurred in earning income that is non-assessable non-exempt under section 23AH of the ITAA 1936.[21] This treatment of the overseas permanent establishments of an Australian entity is consistent throughout Division 820 of the ITAA 1997, as the Australian entity's overseas permanent establishments are also excluded in determining the Australian entity's maximum allowable debt or minimum capital amount.[22]

27. Debt deductions incurred in deriving foreign branch income should be 'attributable to an overseas permanent establishment of the entity' for the purposes of Division 820 of the ITAA 1997.[23] The term 'attributable' is not defined for the purposes of Division 820. The ordinary meaning of the word denotes something like 'belonging to' or 'caused by'.[24]

28. To be exempt under section 23AH of the ITAA 1936, subsection 23AH(2) requires that the relevant income be derived in carrying on a business at or through a permanent establishment of the company in a foreign country. The preposition 'at' denotes the location where business is done: that is, at that place. The preposition 'through' conveys a sense of instrumentality or agency, which is used to accommodate the extension of the definition to a place where someone else, an agent, carries on business at that place. Foreign branch income will be income derived by the company from transacting business at that place.

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[17] See paragraphs 3.7 and 5.6 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.
[18] See paragraphs 3.25 and 5.22 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.
[19] See paragraph 1.18 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.
[20] See sections 820-1, 820-85 and 820-300 of the ITAA 1997.
[21] See sections 820-85 and 820-300 of the ITAA 1997.
[22] See sections 820-95, 820-100, 820-105, 820-310, 820-315 and 820-320 of the ITAA 1997.
[23] As subsection 23AH(2) of the ITAA 1936 applies to 'income derived at or through a PE' and sections 820-85 and 820-300 of the ITAA 1997 only apply to a debt deduction 'to the extent that it is not attributable to an overseas permanent establishment', subject to exceptions to these primary rules, it is likely that costs incurred in deriving income that is subject to section 23AH of the ITAA 1936 will also be subject to the exceptions in either section 820-85 or 820-300 of the ITAA 1997.
[24] 'Attribute to' is defined as meaning 'to consider as belonging to' and 'to consider as caused by': *The Macquarie Dictionary*, [Online], viewed 20 April 2015, www.macquariedictionary.com.au.

29. Borrowing costs incurred by the company in funding the branch business transactions should therefore have the requisite 'belonging to' or the necessary 'causal connection' with foreign branch income such that they will be attributable to the permanent establishment. As a consequence, such costs will be outside the limitations imposed by the thin capitalisation regime.

30. A policy approach could have been adopted under which the general rule in Division 820 of the ITAA 1997 extended to all debt deductions, including those attributable to overseas permanent establishments. However, a deliberate decision was made to make an exception for debt deductions attributable to overseas permanent establishments. Fundamentally, these deductions differ from other deductions covered by section 25-90 of the ITAA 1997 because they fall for consideration as to deductibility in the country of the permanent establishment. Were these deductions also subject to section 25-90, there would likely be significant 'double deductions' for the same financing costs.

31. As such, debt deductions attributable to overseas permanent establishments are treated fundamentally differently from other debt deductions relating to offshore non-assessable non-exempt income: they are not within section 25-90 of the ITAA 1997 (so no deduction is available to the extent the relevant branch income is exempt under section 23AH of the ITAA 1936) but also they are not included in the calculation of debt that is subject to Division 820 of the ITAA 1997 limitations.

Extrinsic materials

32. The scope of section 25-90 of the ITAA 1997 and its interaction with thin capitalisation is explained in the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001:

> 1.99 Debt deductions will, in certain instances, no longer be denied to taxpayers because they were incurred in earning exempt foreign income. These debt deductions, provided they are otherwise allowable under the general deduction provisions, will come within the scope of the thin capitalisation regime when determining the amount to be allowed.
>
> 1.100 The relevant debt deductions are those incurred in earning foreign income that is exempt income under sections 23AI, 23AJ and 23AK of the ITAA 1936.
>
> 1.101 Debt deductions incurred in deriving income which is exempt under section 23AH will continue to be subject to the exempt income exception in section 8-1.[25]

33. The interaction of thin capitalisation and section 25-90 of the ITAA 1997 is further explained in the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001 as follows:

> 5.6 The new thin capitalisation regime will impose a limit on the extent to which the Australian operations of Australian banks can be funded by debt. Accordingly, the current limitations on interest deductions will be removed in so far as they apply to debt deductions that are regulated by the new thin capitalisation regime. Therefore, expenses relating to those deductions will be able to be deducted when incurred in earning exempt foreign income and will no longer be quarantined, subject to the limits imposed by the new thin capitalisation provisions.[26]

[25] See paragraphs 1.99-1.101 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.

[26] Refer also to the explanation in respect of the Australian outward investors generally in paragraph 3.4 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001.

34. Perhaps most pointedly, the relationship between thin capitalisation, section 25-90 of the ITAA 1997 and section 23AH of the ITAA 1936 is explained as follows:

> 5.54 Consequential amendments are mentioned in Chapter 1. Of particular relevance to Australian banks would be the amendments to section 160AFD of the ITAA 1936 and the insertion of section 25-90 in the ITAA 1997. *It should be noted that neither of these amendments relates to debt deductions attributable to the foreign branches of an Australian bank*.[27] [emphasis added]

Section 25-90 in context

35. The context explained above makes plain that the thin capitalisation regime is intended to limit certain debt deductions and, to the extent that deductions are so limited by Division 820 of the ITAA 1997, the other limitations on debt deductions (imposed by section 8-1 of the ITAA 1997 and the then section 79D of the ITAA 1936) were to be removed. These limitations were, in part, removed by the introduction of section 25-90 of the ITAA 1997, which allows deductions for certain costs incurred in earning foreign source income; however, the amount of that deduction was to be limited by Division 820 of the ITAA 1997.

36. Income that is non-assessable non-exempt income pursuant to section 23AH of the ITAA 1936 may also be non-assessable non-exempt income pursuant to section 768-5 of the ITAA 1997. However, for the purposes of Division 820 of the ITAA 1997, a debt deduction incurred in deriving that income is attributable to the overseas permanent establishment of the outward investing entity, and is not subject to the deduction limits imposed by Division 820 of the ITAA 1997.[28]

37. To interpret section 25-90 of the ITAA 1997 as allowing a deduction for a cost incurred in deriving income that is non-assessable non-exempt income under section 23AH of the ITAA 1936 would be inconsistent with the context in which section 25-90 of the ITAA 1997 was enacted and the mischief it was intended to address.

38. The context of section 25-90 of the ITAA 1997 suggests that 'under' in paragraph 25-90(b) of the ITAA 1997 means something akin to 'by virtue of' or even 'only by virtue of'. That is, where an amount meets the requirement of both section 768-5 of the ITAA 1997 and section 23AH of the ITAA 1936, it is not non-assessable non-exempt *under* section 768-5 of the ITAA 1997 because, were it not for section 768-5 of the ITAA 1997, the income would still be non-assessable non-exempt income pursuant to section 23AH of the ITAA 1936.[29]

39. It is therefore considered that income that meets the requirements for exemption in both section 23AH of the ITAA 1936 and section 768-5 of the ITAA 1997, is not 'non-assessable non-exempt income *under* section 768-5 [of the ITAA 1997]' for the purposes of section 25-90 of the ITAA 1997, and therefore any cost incurred in deriving such income is not deductible under section 25-90 of the ITAA 1997.

40. This interpretation of section 25-90 of the ITAA 1997 is to be preferred over the alternative interpretation under which an Australian taxpayer could obtain debt deductions without any limitation under Division 820 of the ITAA 1997 and contrary to the deliberate decision to treat debt deductions attributable to overseas permanent establishments as an exception to the general approach under Division 820 and section 25-90.

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[27] See paragraph 5.54 of the Explanatory Memorandum to the New Business Tax System (Thin Capitalisation) Bill 2001. See also paragraph 3.39.
[28] Refer sections 820-1, 820-85 and 820-300 of the ITAA 1997.
[29] This could also be true the other way around, if it were relevant.

References

Previous draft:

TD 2015/D1

Related Rulings/Determinations:

TR 2005/2; TR 2006/10; TD 2009/21

Legislative references:

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- ITAA 1936 6AB(1)
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- ITAA 1936 23AH(15)
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