Taxation Determination

Income tax: where a taxpayer has supplied or acquired property under an international agreement and that gives rise to a debt interest or an equity interest as defined for the purposes of Division 974 of the *Income Tax Assessment Act 1997*, does Division 974 bear upon the characterisation to be adopted for the purposes of the application of Division 13 of Part III of the *Income Tax Assessment Act 1936* to the transaction?

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Ruling

1. No. Where it is relevant to distinguish between debt and equity in the application of Division 13 of Part III (Division 13) of the *Income Tax Assessment Act 1936* (ITAA 1936) to a supply or acquisition of property, the characterisation is not affected by Division 974 (Division 974) of the *Income Tax Assessment Act 1997* (ITAA 1997), should Division 974 have application to the scheme under consideration. Division 974 provides a test for determining whether an interest is to be treated as a debt interest or an equity interest for particular tax purposes that do not include the application of Division 13.

Date of effect

2. This Determination applies to years of income commencing both before and after its date of issue. 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 paragraph 75 to 77 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
16 July 2008

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

3. Division 13 permits the Commissioner to apply an arm's length consideration in assessing the correct amount of income or deductions in connection with the supply or acquisition of property by the taxpayer under an international agreement,[1] where it is considered that the parties were not dealing at arm's length with each other. Property for these purposes includes funds.[2]

4. Hence, where under an international agreement the taxpayer has received or made a contribution of funds, the question that can arise under Division 13 is whether a certain return would be expected on the funds, and if so, of what amount. The answer is determined by application of the arm's length principle, that is, by what might reasonably be expected under an agreement between independent parties dealing at arm's length.[3] In the application of this test it may, according to the particular circumstances, be important to establish whether the contribution of funds under the agreement was equivalent to equity rather than as a loan.[4] The factors that are taken into account include the legal effect of the transaction and other relevant matters.[5] Thus, one would expect that where a contribution of funds is ordinary equity, the arm's length consideration (that is the rights created in issuing shares) would not include a defined rate of dividend in or over a given period. On the other hand, if the funds are provided as a loan or de facto loan, under Division 13 the consideration given and received would normally be expected to include payments from one party to the other reflecting an arm's length rate of interest.

5. Division 974 provides tests to determine whether a scheme, or the combined operation of a number of schemes, gives rise to a 'debt interest' or an 'equity interest'. Subsection 974-10(1) of the ITAA 1997 provides that the test for determining whether a scheme (or schemes in combination) gives rise to a debt interest or an equity interest is relevant for 'particular tax purposes'. These particular tax purposes include whether any return payable on the interest may be deductible to or is frankable by the issuer. The Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001 sets out the provisions dealing with international taxation to which the debt interest and equity interest definitions in Division 974 are relevant. No mention is made of Division 13, consistent with the intent that no provision limits the operation of Division 13.[6]

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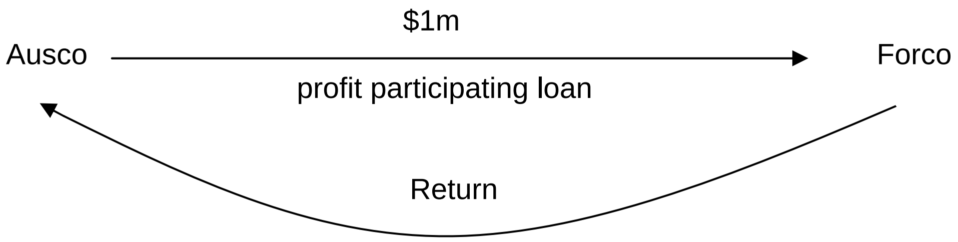
[1] Broadly 'international agreement' as defined in section 136AC of ITAA 1936 concerns agreements for the supply or acquisition of property by a non-resident otherwise than in connection with a permanent establishment of the non-resident in Australia, agreements for the supply or acquisition of property by a resident in respect of business outside Australia and agreements for the supply or acquisition of property in connection with a business conducted in an area covered by an international tax sharing treaty.
[2] 'Property' is defined in subsection 136AA(1) of ITAA 1936 and includes 'services' (also defined).
[3] See subsection 136AA(3) of the ITAA 1936.
[4] See Taxation Ruling TR 1992/11, Part C, paragraph 51.
[5] See Taxation Ruling TR 1992/11, Part C, paragraph 51.
[6] Subsection 136AB(1) of ITAA 1936 provides that nothing in the Act (other than Division 13) limits the operation of Division 13.

6. Accordingly, where an Australian resident company subscribes for securities issued by a non-resident subsidiary company, the treatment of the interest in the non-resident as a debt interest or an equity interest under Division 974 (should it be an instance where Division 974 also has application to a ‘particular tax purpose’) would not be considered relevant to the Division 13 issue of whether the return promised to the subscriber under the terms of the securities is an arm’s length consideration.

Example



7. Assume for the purposes of Division 974 the contribution of funds is categorised as equity. From a Division 13 perspective the Division 974 characterisation is irrelevant in applying the arm’s length principle in determining, for example, an arm’s length rate of interest. Depending on the circumstances it might be concluded that an arm’s length lender would receive a regular interest payment throughout the life of the loan.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the binding public ruling.

Alternative views

8. It has been suggested that if a capital contribution is characterised as an equity interest under Division 974 this should dissuade the Commissioner from making a determination under Division 13 to impute interest income in respect of that contribution of funds.

9. In support of this argument reliance has been placed on paragraph 51 of Taxation Ruling TR 1992/11. Part C of TR 1992/11 deals with determining for Division 13 purposes whether an agreement that is in legal form a loan should be treated as equivalent to a contribution of equity. Paragraph 51(c) of TR 1992/11 states:

> An example of a circumstance in which Division 13 would not be applied to impute interest income would be the case where the Commissioner is satisfied that the contribution of funds should be treated as equivalent to an equity investment.

10. The principal factors relevant to determining whether an agreement, that is in legal form a loan, is to be treated as equivalent to a contribution to equity for the purpose of applying the arm's length principle under Division 13 are as set out in paragraph 60 of TR 1992/11. The definition of debt interest and equity interest in Division 974 does not, nor is intended to, supplant these factors.

References

Previous draft:
TD 2008/D3

Related Rulings/Determinations:
TR 1992/11; TR 2006/10

Subject references:
- arm's length
- debt interest
- equity interest
- transfer pricing

Legislative references:
- ITAA 1936 Pt III Div 13
- ITAA 1936 136AA(1)
- ITAA 1936 136AA(3)
- ITAA 1936 136AB(1)
- ITAA 1936 136AC
- ITAA 1997 Div 974
- ITAA 1997 974-10(1)
- TAA 1953

Other references:
- Explanatory Memorandum to the New Business Tax System (Debt and Equity) Bill 2001

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