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Tax insights
ATO releases draft guidance: section 974-80

Snapshot

- The Australian Taxation Office (ATO) has released two Draft Taxation Determinations (TDs) addressing certain aspects of section 974-80 of the Income Tax Assessment Act 1997.
- The Draft TDs are a welcome development as they provide useful guidance on two threshold technical issues that have led to uncertainty in the potential application of section 974-80 to some straightforward and commonplace inbound funding structures.
- However a number of important issues remain unanswered by the Draft TDs.

Background

On 12 November 2014, the ATO released two Draft TDs on certain aspects of section 974-80. The Draft TDs, when finalised, are proposed to apply before and after the date of issue.

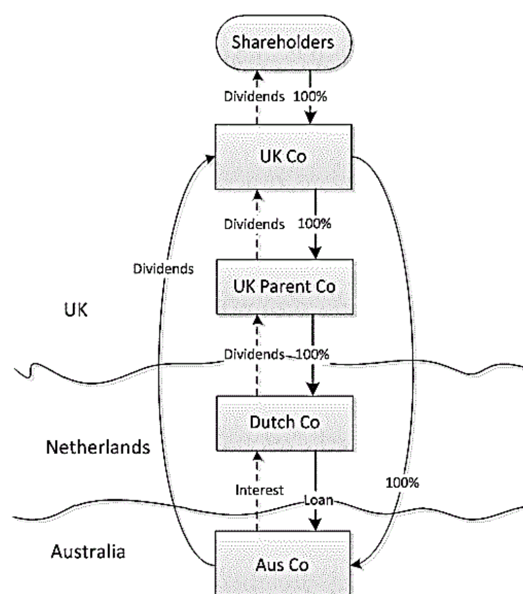
Section 974-80 was intended to act as an integrity provision to ensure that for tax purposes, debt treatment is not extended to arrangements where a debt interest is issued to a connected entity, and the return paid to the connected entity is used to fund an equity-like return on investment held by a third person (the “ultimate recipient”). The effect of section 974-80 is to re-characterise the debt interest issued by the underlying company to equity, which effectively denies deductibility for the interest that the underlying company might pay on the relevant debt funding.

As a result of the broad drafting of the provision, the potential application of section 974-80 presents taxpayers with considerable uncertainty. However the recently released Draft TDs appear to signal a pragmatic approach on the part of the ATO to interpreting some of the threshold requirements for the application of the provision.

TD 2014/D18

The first of the Draft TDs, TD 2014/D18, addresses the question of whether section 974-80 applies where interest paid by an Australian entity to a connected entity might be used to fund a dividend paid to an ultimate recipient.

To address this question, TD 2014/D18 presents the following specific example and accompanying diagram:



In the example, Aus Co pays interest to Dutch Co, a special purpose vehicle whose only asset is the loan to Aus Co. Dutch Co in turn pays dividends to UK Parent Co (and perhaps significantly, the example states that UK Parent Co is the holding company for the group's non-UK resident entities, although only Dutch Co is depicted in the diagram). UK Parent Co then pays dividends to UK Co "out of a pool of dividends received from subsidiaries, including Dutch Co." UK Co in turn pays dividends to its shareholders.

The issue addressed by TD 2014/D18 is the application of paragraph 974-80(1)(d), a threshold provision that requires the existence of "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)."

As all the companies in the above example are connected entities (being members of the same wholly-owned corporate group), TD 2014/D18 essentially explores the question of whether the interest paid by Aus Co to Dutch Co could be regarded as being part of scheme that is designed to operate to fund the dividends ultimately paid to UK Co's shareholders.

The ATO concludes that paragraph 974-80(1)(d) will not be satisfied, stating that although the interest paid by 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 shareholders", this is an "insufficient basis" to conclude that the scheme is designed to operate to use the interest paid to Dutch Co to fund dividends to UK Parent Co. Instead TD 2014/D18 states that there must be a "stronger connection" between the interest payment and the dividends in order to conclude that the dividends paid to UK Co's shareholders are indirectly a return from Aus Co.

TD 2014/D19

The second Draft TD, TD 2014/D19, addresses a more technical issue associated with subsection 974-80(2). Subsection 974-80(2) ends with the phrase:

> …and if the interest does not form part of a larger interest that is characterised as a debt interest in the entity in which it is held, or a connected entity, under Subdivision 974-B. [Emphasis added]

The question that TD 2014/D19 addresses is whether that last reference to "the interest" in subsection 974-80(2) is a reference to the interest held by the ultimate recipient, as opposed to the interest held by the interposed connected entity.

In resolving this technical question, TD 2014/D19 makes reference to the Explanatory Memorandum which states that section 974-80 is not intended to apply if the ultimate recipient's interest satisfies

the debt test, and concludes that the last reference to “the interest” in subsection 974-80(2) is a reference to the interest held by the ultimate recipient.

Deloitte comments

The release of TD 2014/D18 is a positive development and signals a pragmatic approach to the relatively straightforward type of inbound cross-border funding arrangements illustrated in the above example. However, TD 2014/D18 leaves some important issues unanswered.

For example, the ATO does not elaborate on what would constitute a “stronger connection” between the interest paid to Dutch Co and the subsequent payments of dividends so as to satisfy paragraph 974-80(1)(d).

It does seem significant however that in the example the ATO stipulates that UK Parent Co holds investments in a number of other non-UK subsidiaries (which are not depicted in the illustration accompanying the example) and pays its dividends “out of a pool of dividends received from subsidiaries including Dutch Co”. The co-mingling of the dividends from Dutch Co with those received from other subsidiaries presumably weakens the connection between the interest receipts of Dutch Co and the subsequent dividends paid by UK Parent Co, although TD 2014/D18 does not give any indication of the relative proportions of the dividend income from those other subsidiaries; nor does TD 2014/D18 specifically elaborate on how the analysis would be impacted if UK Parent Co were not to receive dividends from subsidiaries other than Dutch Co.

TD 2014/D18 also does not provide clear guidance on identifying the “ultimate recipient”, which is an important concept for the application of section 974-80. TD 2014/D18 seems premised on the shareholders of UK Co being the ultimate recipients; however TD 2014/D18 does not discuss whether, for example, UK Parent Co could also be regarded as an ultimate recipient and, if so, what effect this would have on the section 974-80 analysis.

This is important because the only source of funding for dividends paid by Dutch Co is the interest that it receives from Aus Co; thus the dividends paid by Dutch Co are not out of a “pool of funds” obtained from various other sources. It is therefore not completely clear how the ATO’s analysis would be affected if UK Parent Co were to be regarded as an ultimate recipient.

In contrast, TD 2014/D19 is more technical in nature. Whilst it is interesting that TD 2014/D19 makes reference to a statement in the Explanatory Memorandum that suggests that section 974-80 is not intended to apply where the ultimate recipient’s investment is a debt interest, the ATO does not explicitly state that it will always interpret section 974-80 in this way.

Section 974-80 is presently under review by the Board of Taxation as part of its broader review of the debt and equity tax rules, and to date the Board of Taxation has provided no public indication of the recommendations that it might make in relation to the provision. In the meantime the Draft TDs should provide some useful guidance to taxpayers on the ATO’s approach to some of the technical issues that have to date driven much uncertainty surrounding section 974-80.

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