

ATO provides guidance on equity over-ride rule

12 November 2014

The Australian Taxation Office (ATO) has today provided some long awaited guidance on the application of the equity over-ride rule in section 974-80 of the *Income Tax Assessment Act 1997*. There is still a long way to go in rectifying all of the uncertainty associated with this provision. However, today's draft determinations provide welcome certainty to many taxpayers that have employed basic inbound investment structures.

Section 974-80 operates to reclassify a debt interest issued by a company to a 'connected entity' as an equity interest. In broad terms, this rule applies if returns on the debt interest are designed to operate so that the connected entity funds an equity-like return to a third person (the 'ultimate recipient'). Where a debt interest is reclassified as an equity interest under section 974-80, distributions on that interest will be treated as dividends (that is, not tax deductible, but frankable).

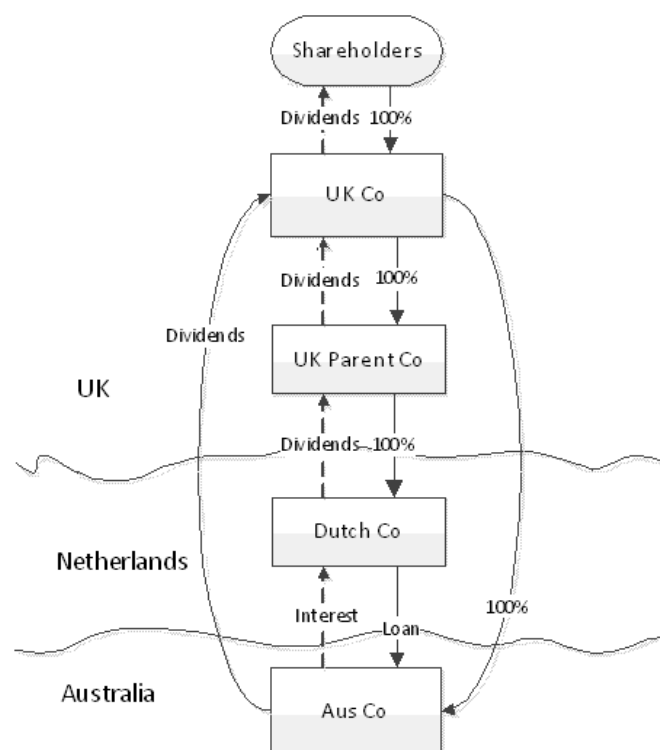
From a policy viewpoint, section 974-80 is a specific measure intended to address concerns that companies can achieve an outcome where, in certain circumstances, the issuer obtains benefits from issuing a debt interest as part of an arrangement (which may involve a series of related arrangements) that provides the ultimate recipient with an effective equity interest in the issuer.

Since its introduction in 2001, the potential application of this provision to many investment structures has been an issue of contention between the ATO and taxpayers. The draft guidance released by the ATO today has addressed the application of section 974-80 to a basic (and very common place) inbound investment structure and overturns aspects of a controversial interpretation of the equity over-ride rule published in a draft ATO paper in March 2007.

Integrity rule should not apply to basic inbound investment structure

In draft Tax Determination TD 2014/D18, the Commissioner of Taxation has provided a preliminary view on the potential application of section 974-80 to an inbound investment structure such as that depicted in the diagram to the right, which is the example used in the draft determination.

Specifically, the Commissioner has indicated that "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) that there is a scheme, or a series of schemes, designed to operate so that the returns on a debt interest are used to fund returns on an equity interest held by another person (the ‘ultimate recipient’)”.

In the context of this example, the draft determination notes that whilst interest payments from Aus Co will ultimately be used as part of a pool of funds used to pay dividends to UK Co shareholders, this is an insufficient basis for concluding that there is a scheme or series of schemes designed to operate so that the interest paid to Dutch Co is used to fund dividends to UK Parent Co.

Furthermore, the draft Tax Determination states (in the non-binding explanation) that “*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*”.

In a related matter, the ATO has also released draft Tax Determination TD 2014/D19 that clarifies that the reference to ‘the interest’ as it appears in the phrase at the end of subsection 974-80(2) is a reference to the interest held by the ultimate recipient and not the “connected entity”.

The determinations, when finalised, are proposed to apply on a retrospective basis.

Comments regarding these 2 draft determinations are due by 12 December 2014.

Re-cap on other work underway regarding section 974-80

In an attempt to remove some of the uncertainty associated with this provision, the former Government announced in the 2011-12 Federal Budget that section 974-80 would be amended retrospectively to ensure that it only applies to arrangements where both the purpose and effect is that the ultimate investor has, in substance, an equity interest in the issuer company, and to provide the Commissioner with discretion to disregard the integrity provision where he considers that it would be unreasonable to apply it. The amendments are proposed to apply from 1 July 2001.

Whilst these amendments have yet to be enacted, the current Government has confirmed that it will proceed with these amendments, and the design of these measures is being considered as part of a post-implementation review of the debt/equity provisions currently being conducted by the Board of Taxation. The Board of Taxation is due to report to Government on this review by March 2015. Whilst the guidance released today by the ATO certainly goes some way to dealing with the issues surrounding this integrity provision, there is clearly still much ground to cover, and in the interests of taxpayers that have been grappling with this issue for over a decade now, it is hoped that this issue is given high priority within Government.

Let’s talk

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