Corporate Tax Update

1 March 2014

Draft Taxation Determination on parent company support payments

On 29 January 2014, the Commissioner of Taxation released draft Taxation Determination TD 2014/D7 which sets out the Commissioner's preliminary view that capital support payments are not deductible under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) because they are capital in nature, and are not deductible under Division 230 of the ITAA 1997 because they are not a loss from a financial arrangement. In addition, the Commissioner's preliminary view is that such payments are included in the capital gains tax cost base and reduced cost base of the parent company's investment in the subsidiary company, with the consequence that they are therefore not deductible under section 40-880 of the ITAA 1997.

TD 2014/D7 was previously issued as draft Taxation Determination TD 2013/D3, with TD 2014/D7 containing substantial changes from the previous draft, including:

- specifying that the draft Determination relates only to ‘capital support payments’ (as opposed to just ‘support payments’ in TD 2013/D3) and defining this term in detail; and
- dealing with the deductibility of capital support payments under the taxation of financial arrangement (TOFA) provisions in Division 230.

The draft Taxation Determination applies to arrangements that meet the criteria in paragraph 4 of TD 2014/D7, being arrangements that have all of the following features:

a. A parent entity (‘parent’) agrees to provide its subsidiary with one or more of the following:
   - a lease, license or other right to use one or more assets, not being money or money equivalent
   - a legal or equitable interest in one or more such assets, or
   - services.

b. The subsidiary agrees to provide consideration to the parent for the things referred to in paragraph (a).

c. The parent also agrees to make a payment to the subsidiary which, objectively:
   - is made because all or a part of the subsidiary, has made a loss or losses,
   - is not, in the opinion of the parent entity or as agreed between the parent entity and one or more other parties (such as the subsidiary and/or a third party) sufficiently profitable (such as may be the case if the profit of the subsidiary is less than an agreed benchmark), or
   - would or is likely to have made a loss or losses, or not have been sufficiently profitable in the sense used above, were it not for that payment, and
   - the payment referred to in paragraph (c) does not have the character of:
     - a price for assets or services supplied by the subsidiary to the parent.
– an adjustment to the price of assets or services supplied by the parent to the subsidiary or by the subsidiary to the parent or
– a loan to the subsidiary or the repayment of such a loan.

d. The parent’s obligation to provide the things referred to in paragraph (a) is not insignificant compared with the rights and obligations referred to in paragraphs (b) and (c).

A payment made as part of an arrangement described above is a capital support payment for the purposes of TD 2014/D7 to the extent that it satisfies paragraph (c).

In relation to the deductibility of such payments under section 8-1 of the ITAA 1997, the explanation in Appendix 1 of TD 2014/D7 states that neither of subsection 230-15(2) or 230-15(3) of the ITAA 1997 apply to a capital support payment, since such a payment is not a loss from a ‘financial arrangement’.

According to the Commissioner, this is because under the arrangement defined in TD 2014/D7, the parent has an obligation to provide things which are not cash settable and that obligation is significant. The conclusion in TD 2014/D7 is that the parent’s obligation to make payments and right to receive consideration is not, and is not part of, a ‘financial arrangement’ for the purposes of section 230-45 of the ITAA 1997.

Once finalised, this determination is proposed to apply both before and after its date of issue.

For further information in relation to this draft Taxation Determination, contact Wayne Plummer on 02 8266 7939.

Dividend access share arrangements and the Commissioner’s application of anti avoidance rules

On 26 February 2014 the Commissioner of Taxation published Taxation Determination TD 2014/1 Income tax: is the ‘dividend access share’ arrangement of the type described in this Taxation Determination a scheme ‘by way of or in the nature of dividend stripping’ within the meaning of section 177E of Part IVA of the Income Tax Assessment Act 1936?

According to the Commissioner dividend access share arrangement described in TD 2014/1 will attract the operation of section 177E of Part IVA of the Income Tax Assessment Act 1936 (ITAA 1936) with adverse tax implications for affected taxpayers.

Briefly, the arrangement described in TD 2014/1 involves:

• A private company (The ‘target’ company) with accumulated significant profits which have been taxed at the corporate tax rate.

• The ordinary shares in the target company are held by an individual or individuals (original shareholders) one or more of whom is a director of the target company.

• The Constitution of the target company is amended to allow the creation of a new class of shares (Z Class).

• The Z Class shares have a right to receive dividends at the discretion of the target company’s directors, no voting rights and no rights to participate in surplus assets on winding up of the target company.

• The Constitution of the target company is amended to allow the creation of a new class of shares (Z Class).

• The Z Class shares have a right to receive dividends at the discretion of the target company’s directors, no voting rights and no rights to participate in surplus assets on winding up of the target company.

• The target company has a right to redeem the shares within 4 years of issue, with the shares ceasing to exist at the end of 4 years (i.e. if not redeemed by the target company). This timeframe seeks to access a particular exemption in the direct value shifting provisions of the income tax law.

• The target company issues Z Class shares for nominal consideration to either a
company controlled by the original shareholders or to a company acting as trustee of a discretionary trust.

- The target company declares and pays a fully franked dividend on the Z Class shares of an amount approximately equal to the target company’s accumulated profits. This dividend is satisfied by the issue of a promissory note by the target company.

- A series of transactions are then carried out that have the effect of ensuring that the original shareholders and/or their associates receive the economic benefit of the target company’s profits in a tax free or substantially tax free form. An example included in TD 2014/1 is where the dividend on the Z Class shares is paid to a company which is owned by a discretionary trust that recipient company pays no tax because of the franking rebate. Subsequent dividends paid by the recipient company are then channelled through the discretionary trust to tax preferred entities such as non-resident associates of the original shareholders, other related individuals exposed to a lower marginal tax rate, or entities with carried forward tax losses.

Where Section 177E applies, the general affect is that the original shareholders will be assessable on the dividend paid on the dividend access share, and this dividend will not be franked (even if the dividend on the dividend access share was franked). On application, the Commissioner may determine that the dividend paid on the dividend access share should not be included in assessable income of the holder of the dividend access share. If the Commissioner exercises his discretion to so exclude the dividend access share from assessable income, there will be no ‘double tax’, with only the original shareholders being assessable. In addition however, administrative penalties under the scheme penalty provisions of the income tax law will apply, and these will be assessed to the original shareholders calculated by reference to the tax underpaid on assessment i.e. before the application of section 177E.

It is relevant to note that in applying section 177E, that the Commissioner has taken the position that there is a dividend stripping operation (or a scheme having that effect), notwithstanding that the original shareholders are not ‘vendor shareholders’ as would typically be found in a dividend stripping operation. Perhaps this is because the Commissioner concluded that other relevant anti-avoidance provisions such as section 177EA, may not apply in the circumstances outlined in TD 2014/1.

Whether the general anti-avoidance provisions (which contain section 177E) apply will ultimately depend upon the circumstances of each case and may well be a matter to be decided before the courts.

In TD 2014/1 the Commissioner does not dismiss the possibility that other provisions of the income tax law may apply to these types of arrangements depending on the facts of the case.

Companies that have issued dividend access shares of the type described in TD 2014/1 should as a matter of urgency seek advice regarding these arrangements. It would also be prudent for companies with dividend access arrangements that are not the same as those described in TD 2014/1 to nonetheless reconsider the tax efficacy of their arrangements having regards to the Commissioner’s views in TD 2014/1 as to the circumstances in which, according to the Commissioner, section 177E will be enlivened.

If you have any queries regarding this item or would like to discuss matters further, contact Kel Fitzalan on +61 (2) 8266 1600.
Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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