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Ruling Compendium – TD 2008/20

This is a compendium of responses to the issues raised by external parties to draft TD 2008/D3 – 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?

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

Summary of issues raised and responses

Issue No.	Entity/s commenting	Issue raised	Tax Office Response/Action taken
1.		Can Division 13 of Part III (Division 13) of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936) apply to returns on securities that are in legal form equity?	<p>A contribution of funds may be a supply of property under an international agreement between parties that are not dealing at arm's length with each other. However, it does not follow that a Division 13 of Part III (Division 13) of the <i>Income Tax Assessment Act 1936</i> (ITAA 1936) determination is made.</p> <p>Importantly, Division 13 requires the application of the arm's length principle. That is, what might reasonably be expected under an agreement between independent parties dealing at arm's length. (See paragraphs 136AA(3)(c) & (d) of the ITAA 1936 and for example TR 1994/14 at paragraphs 54 and 71).</p> <p>All contributions of funds are subject to this principle where property has been supplied under an international agreement and the parties are not dealing at arm's length in relation to the supply. With loans, for example, see TR 1992/11 paragraphs 20 and 82(b).</p>

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			<p>When a taxpayer contributes funds and receives ordinary shares, it would not be reasonable to expect that consideration equal to arm's length dividend be received and payable as a return on the contribution of funds. This is not what independent parties would agree to in a comparable transaction.</p> <p>Two sentences have been inserted in paragraph 4 to clarify Division 13's operation with ordinary equity:</p> <p><i>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 a 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.</i></p> <p>If further clarification on this matter is needed a separate ruling or determination is preferred.</p>
2.		Change the words 'contribution of funds' to 'an agreement for or in relation to the lending of money'. The words 'contribution of funds' results in the ATO concluding that Division 13 can apply to determine the arm's length return on equity instruments.	<p>See the response to issue 1.</p> <p>The broad expression, contribution of funds, is necessary because transactions that may fall for consideration under Division 974 (Division 974) of the <i>Income Tax Assessment Act 1997</i> (ITAA 1997) and Division 13 are themselves broad.</p>
3.		Insert an example to clarify the ramifications of the Determination for taxpayers.	An example has been inserted after paragraph 6.
4.		Update TR 1992/11.	It is recommended that a rewrite of TR 1992/11 be considered for inclusion onto the Rulings program.

5.		<p>Paragraph 6 is at odds with the High Court decision in <i>Ord Forrest v. FCT</i> (1973-1974) 130 CLR 124, where the issue of shares by way of subscription was held not to constitute property.</p>	<p><i>Ord Forrest Pty Ltd v. Federal Commissioner of Taxation</i> (1973-1974) 130 CLR 124 (<i>Ord Forrest</i>) found that the allotment of shares is not a disposal of the property of the issuer. For example, Mason J at 155 of the decision says:</p> <p>An unissued share in the capital of a company is not property; it is no more than a unit or fraction of the company's nominal capital which may be issued in accordance with the provisions of the memorandum and articles of association. When allotted, but not before, it bears the character of a proprietary right, a chose in action that is vested in the shareholder.</p> <p>The allotment of shares in a company is certainly not a disposition of the company's property; nor, for the reasons already stated, can it be described with accuracy as a "disposition of property" in the ordinary sense of that expression.</p> <p>See TR 2008/D1 for the preliminary Tax Office view on the <i>Ord Forrest</i> decision.</p> <p>Once the share is allotted it is property, a chose in action. <i>Property, supply, acquire</i> are defined widely in subsection 136AA(1) of the ITAA 1936. They are not defined by reference to the disposal of property.</p> <p>Note, in the context of the TD the property is the contribution of funds – the cash.</p>
6.		<p>The characterisation of an interest as either debt or equity may be a matter that could be taken into account in the context of whether the discretion in paragraph (d) of subsections 136AD(1), (2) and (3) is exercised.</p>	<p>While Division 974 does not bear upon the characterisation to be adopted in the application of Division 13, how Division 974 applies to the arm's length consideration is a matter that may assist in determining whether there has been profit shifting.</p>