TD 2014/14EC - Compendium

Ruling Compendium – TD 2014/14

This is a compendium of responses to the issues raised by external parties to Draft Taxation Determination TD 2014/D7 *Income tax: are the capital support payments described in this Draft Determination deductible under section 8-1, section 40-880, subsection 230-15(2) or subsection 230-15(3) of the Income Tax Assessment Act 1997?*

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

Summary of issues raised and responses

Issue No.	Issue raised[1]	ATO Response/Action taken[2]
1. Section 8-1: characterisation		
1.1	**Circumstances to be considered**	
	As characterisation of expenditure for the purposes of section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997) is to be derived from looking at the circumstances as a whole, the Determination should explicitly state that all relevant facts and circumstances are to be considered.	It is considered that the payments in question have been identified in a way which enables them to be characterised by reference to their connection, or lack of connection, to profitability and pricing. The Determination now states that all of the facts and circumstances must be taken into account in determining: • whether a payment is objectively made because the subsidiary made a loss or is insufficiently profitable, and • whether a payment has the character of a price or a price adjustment. See paragraphs 5 and 43.

[1] References in this column are references to Draft Tax Determination TD 2014/D7.
[2] References in this column are references to Tax Determination TD 2014/14.

Issue No.	Issue raised[1]	ATO Response/Action taken[2]
1.2	**Significance of profit-linkage**	
	The Determination should clearly state that the fact that a support payment is profit-based is just one factor that should be taken into account and, of itself, is generally not determinative.	Whilst a linkage between a payment and profitability is not determinative, it is strongly suggestive of capital characterisation where profitability is affected by factors other than the quantity or quality of what (if anything) is being supplied between the parties. See paragraphs 6 and 51.
1.3	**Sun Newspapers - second and third tests**	
	The Determination should give full consideration to the second and third tests in *Sun Newspapers v. Federal Commissioner of Taxation* (1938) 61 CLR 337; 1 AITR 403; 5 ATD 87	The 'character of the advantage sought' test is considered to be of most assistance in characterising payments of the kind considered in the Determination. See paragraphs 70-80. See also, Issue No. 4.3 in TD 2014/D7EC.
1.4	**Meaning of 'services'**	
	It is somewhat contradictory to say that a subsidiary does not provide a service by bearing risks associated with its parent's intangibles; but does provide a service by performing acts the subsidiary would not otherwise be expected to undertake.	In the Determination the term 'service' now refers to acts for which an independent, arm's length party would ordinarily expect to receive payment. See paragraphs 11 and 48-50.

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1.5	**Connection between subsidiary's business and parent's business**	
	Where the subsidiary is conducting business activities that are essentially a division or extension of the parent company's business, the purpose of the support payment is carrying on the income producing activities of the parent's business and the payment is in the nature of a periodic working expense.	The business of a subsidiary is that of the subsidiary and not of the parent, irrespective of how closely the parent may monitor the subsidiary's activities.[3] An entity does not carry on a business merely because it controls the entity carrying on a business activity.[4] Where the subsidiary provides a benefit to its parent through the carrying on of its business activities, there may be a question as to whether the subsidiary is in fact providing a 'service' to the parent, payment for which could be considered to be a deductible 'working' expense. The meaning of the term 'service' has been revised. See Issue No. 1.4. See further, Issue No. 4.2. in TD 2013/D7EC.
1.6	**Time period for payments**	
	The Commissioner should clarify his view on the treatment of support payments made over an extended period of time.	Capital support payments are considered to be a capital contribution, or to have substantially the effect of a capital contribution. Accordingly, the length of time over which the payments are made would not of itself change the conclusion in the Determination. See paragraphs 71-74.

[3] For example *FC of T v. Tasman Group Services* [2009] FCAFC 148 at paragraph 56; 2009 ATC 20-138; (2009) 74 ATR 739.
[4] *Kodak Ltd v. Clark* [1902] 2 K.B. 450.

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1.7	**BP Australia and National Australia Bank**	
	The principles arising from *BP Australia Ltd v. Federal Commissioner of Taxation* (1965) 112 CLR 386; 9 AITR 615; 14 ATD 1 and *National Australia Bank v. Federal Commissioner of Taxation* 97 ATC 5153 are still relevant notwithstanding the different manner of calculation.	Capital support payments are considered to be distinguishable from the arrangements considered in *BP* and *National Australia Bank*. See paragraph 80.
1.8	**Financial and performance guarantees**	
	Financial and performance guarantees should be treated as an 'exception' to 'capital support payments'. They appear to fit within the current definition, as the parent entity is effectively underwriting the activities of the subsidiary.	Capital support payments are amounts paid by a parent to its subsidiary because of the subsidiary's losses or insufficient profits. Accordingly, they do not include payments to third parties under a financial or performance guarantee. See paragraph 4.
1.9	**Apportionment**	
	The Determination should provide additional guidance on how to apportion support payments which are appropriately characterised as partly revenue and partly capital.	Example 3 provides some guidance in this regard. More generally, however, what will be appropriate will essentially be a question of fact, to be determined in each case. See paragraph 82. See further, Issue No. 4.5., TD 2014/D7EC.

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2 Examples		
2.1	**Example 1 - support payment for higher future fees**	
	Example 1 is too dismissive of the possibility that a payment made by Parent Co as a *quid pro quo* for higher licence and service fees could be deductible under section 8-1 of the ITAA 1997.	The Determination acknowledges that the payment made by Parent Co is expressed as a *quid pro quo* for higher licence and service fees. See paragraph 17, dot-point 5. However, in the circumstances described, the payment is objectively made because of the loss and is not a price or price adjustment in respect of the supplies made by the parent. The payment is therefore considered to be of a capital nature for the reasons set out in paragraphs 19-20; see further, paragraphs 70-80.
2.2	**Example 1 - no fees in the year of payment**	
	Example 1 could be taken to suggest that the payment by Parent Co is not deductible merely because no licence and service fee income was received in the same year.	The Determination does not deny deductibility on the basis of the time at which fees are received. Rather, it concludes that the payment could not have the character of an adjustment to a price in circumstances where no price is payable. The Determination acknowledges that the payment may satisfy the positive limb in subsection 8-1(1) of the ITAA 1997. However, it is concluded that the payment is not deductible because it is of a capital nature. See paragraphs 19-20.
2.3	**Example 2 - fees in later years**	
	Reservations in relation to Example 1 are exacerbated by Example 2 where Sub Co has operated profitably and paid licence and service fees for a number of years.	The conclusion in Example 1 is considered to apply equally to Example 2. Example 2 now contains further analysis relating to the conclusion that the payment does not have the character of a price or price adjustment. See paragraph 24.

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2.4	**Example 3 - promotional expenditure**	
	Example 3 is contradictory because it provides that reimbursements of advertising and promotional expenditure are deductible, whilst holding that additional support payments made to obtain a 'target return' are of a capital nature.	Example 3 has been amended to clarify that the services being provided by the subsidiary are paid for through 'Amount A'. On this basis, 'Amount B' does not represent the price of those services, nor an adjustment to such a price. See paragraph 27. The meaning of the term 'service' has been adjusted (see Issue No 1.4 above). For the purposes of the Determination, the subsidiary provides a service where it provides things to the parent for which an independent third party would expect payment. In the example, the subsidiary provides a service by undertaking additional advertising and promotional expenditure.
2.5	**Example 4 - 'Limited risk distributor' terminology**	
	Clarification of the term 'limited risk distributor' in example 4 is needed.	A description of the role of a limited risk distributor has been included in example 4. See paragraph 33, dot-point 5.
2.6	**Example 6 - clarification**	
	The third dot point of Example 6 requires clarification.	Example 6 has been omitted from the Determination.
2.7	**Limited risk distribution vs market penetration and representation**	
	The examples should be further clarified to distinguish support payments made to limited risk subsidiaries from market penetration and representation arrangements.	The Determination recognises that a price-related payment may be deductible, whether the subsidiary is a limited risk distributor or an entity undertaking a market penetration or representation arrangement. In each case, it is necessary to characterise the payment by reference to the principles in paragraphs 4-7.

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3. Taxation of financial arrangements - Division 230		
3.1	**Cash settlable**	
	The justification for the conclusion in paragraph 87 that the obligations are not cash settlable is not readily apparent.	The Determination clarifies that the rights of the subsidiary are not 'cash settlable' within the meaning of subsection 230-45(2) of the ITAA 1997. The obligations referred to would not normally be able to be settled through the provision of money or readily converted into a money equivalent in any event. See paragraphs 4(a), 9 and 88.
3.2	**Footnoted comments**	
	The comments in footnote 30 are important and should be contained in the body of the TD so that they are not overlooked.	The footnote has been moved into the body of the explanation. See paragraph 89.
4. Capital allowances - section 40-880		
4.1	**Objective purpose**	
	Support payments would not be included in the fourth element of the cost base or reduced cost base where there is no objective purpose to increase or preserve the value of the parent company's investment.	The objective purpose of an outlay is determined by reference to what it is apt to achieve;[5] it is an attribute of the transaction whereby money is laid out.[6] It is considered that the objective purpose and effect of a capital support payment is to increase or preserve the value of a parent's investment in the subsidiary. See paragraphs 70-71 and 93.

[5] *FC of T v. Creer* [1986] FCA 140 at paragraph [3] per Wilcox J; 86 ATC 4318; (1986) 17 ATR 548 .
[6] *Magna Alloys & Research Pty Ltd v. Federal Commissioner of Taxation* [1980] FCA 150; 80 ATC 4542, 4544; (1980) 11 ATR 276 at 279; *Robert G Nall Ltd v. Federal Commissioner of Taxation* (1937) 57 CLR 695 at 711; 1 AITR 169 at 176.

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4.2	**National Mutual**	
	The decision in *National Mutual Life Association of Australia v. Federal Commissioner of Taxation* [2009] FCAFC 96, 2009 ATC 20-124; (2009) 76 ATR 608 does not support the proposition that a non-share contribution will always have a purpose or expected effect of increasing or preserving the value of the membership interests and this should be considered on a case by case basis.	The decision in *National Mutual* is provided as an example of a non-scrip contribution which was reflected in the value of shares in a company. See footnote 20.
5. Other Issues		
5.1	**Accounting treatment**	
	The concept of 'payment' should accommodate the fact that in some instances an entity's finance system may not allow intercompany price adjustments to occur on a timely basis. Instead, adjustments are recorded as book entries, which are then reflected as a single year-end adjustment. Since the year-end adjustment captures the aggregate of all intra-year adjustments, it may exceed the price for goods for the quarter.	The definition of 'payment' in the Determination is considered to be sufficiently clear. An end of year payment can be readily characterised by reference to the book entries to which it corresponds. A payment corresponding to to price adjustments made throughout the year cannot be attributed only to book entries made during only part of that period. See paragraphs 10 and 44.

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5.2	**Function of capital support payment**	
	Paragraph 46 – it is more appropriate to describe a capital support payment as 'mitigating' the risk as opposed to 'reflecting' the risk.	This change has been made. See paragraph 47.
5.3	**Effect of Advance Pricing Arrangements (APAs)**	
	It would be preferable for the Determination to state that existing APAs will continue to apply in accordance with their terms, as stated in TD 2014/D7EC, Issue No. 5.1.	The protection afforded by APAs is set out at paragraph 13 of PSLA 2011/1, which states: *Once the APA comes into effect and the taxpayer has agreed to and complies with its terms, the ATO is administratively bound by the terms of the APA. The APA may require the taxpayer to comply with particular requirements, and may depend on critical assumptions being met. If those requirements are complied with and those assumptions met, the Commissioner of Taxation is prevented from imposing any additional income tax on the covered international related party dealings than is payable on the pricing worked out under the APA.*