TA 2020/2 - Mischaracterised arrangements and schemes connected with foreign investment into Australian entities

Mischaracterised arrangements and schemes connected with foreign investment into Australian entities

Alerts provide a summary of our concerns about new or emerging higher risk tax or superannuation arrangements or issues that we have under risk assessment.

While an Alert describes a type of arrangement, it is not possible to cover every potential variation of the arrangement. The absence of an Alert on an arrangement or a variation of an arrangement does not mean that we accept or endorse the arrangement or variation, or the underlying tax consequences.

Refer to PS LA 2008/15 for more information about Alerts. See Alerts issued to date.

Description

We are reviewing cross-border arrangements that mischaracterise the structure used by foreign investors to invest directly into Australian businesses.

Relevant arrangements typically display one or more of the following features:

- The Australian resident entities are unable to obtain capital from traditional external debt finance sources on normal terms.
- The foreign investor either already participates in the management, control or capital of the Australian entity at the time of investment, or starts to participate in the management, control or capital as part of the investment.
- The investment has features not consistent with vanilla debt or equity investments.
- The investment may provide the foreign investor with direct exposure to the economic return from a particular business or assets exploited therein (whether ongoing profit or a gain on disposal).

We will review the tax characterisation adopted by the taxpayer and test its appropriateness having regard to the factual circumstances, relevant tax laws and applicable tax treaties.

We will consider applying the general anti-avoidance rules[1] in circumstances where arrangements are contrived (including, in the case of significant global entities, by diverting profits) to reduce the amount of taxable income, or the amount of withholding tax payable by a taxpayer. The general anti-avoidance rules may apply where a tax benefit or a diverted profits tax benefit is obtained in connection with these arrangements.

We will consider applying the transfer pricing provisions[2] in the taxation law where parties are not dealing wholly independently in relation to the terms or conditions of the

[1] As outlined in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936).
[2] Subdivision 815-B of the *Income Tax Assessment Act 1997* (ITAA 1997).

arrangements, including as it affects amounts deducted by the Australian entity in connection with the arrangements.

Arrangements of particular concern include, but are not limited to, those described in the examples in this Alert.

Example 1:

- *An Australian resident entity raises capital from an offshore third-party investor (whether directly, or through a subsidiary incorporated in a jurisdiction which has a favourable tax treaty with Australia).*
- *The investment is ostensibly made in the form of debt finance, and the return payable by the Australian entity to the offshore investor is calculated at interest rates exceeding those obtainable from traditional debt investors.*
- *There is a contingent additional return payable to the offshore investor in the event the Australian entity sells or divests its assets, with the amount of the return reflecting a share of the sale or divestment proceeds.*
- *The additional return payable to the offshore investor on sale or divestment is treated as not subject to Australian withholding tax or not otherwise subject to Australian tax.*
- *Payment of interest may be deferred until the Australian entity sells its assets.*
- *The Australian entity treats its Australian taxable profit on sale of its assets as reduced by the amount payable to the offshore investor, either in the computation of the capital gain or capital loss, or by deduction of the amount from the entity's assessable income.*

In considering the concerns in this Alert, we will examine the overall facts and circumstances, and the manner in which each party's rights and obligations are protected under the arrangement, in order to determine whether the arrangement is appropriately characterised as debt for various tax purposes.

Example 2:

- *An Australian resident entity that holds a mining right raises capital from an offshore third-party investor.*
- *The offshore investor provides capital funding to the Australian entity in the form of acquisition of a newly created right to receive payments calculated as a percentage of gross revenue from the sale and disposal of natural resources.*
- *A United States resident subsidiary of the offshore investor's parent entity is used to acquire the rights and receive the payments from the Australian entity, taking advantage of particular articles in the double-tax convention between the United States and Australia.*[3]
- *The offshore investor's entity does not in terms obtain a legal interest in the Australian entity's mining right.*

[3] *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1983] ATS 16.

- *The return payable to the offshore investor's entity is treated as not subject to Australian income tax or withholding tax, including pursuant to*
  - *section 6CA of the ITAA 1936, which deems natural resource income to have an Australian source and results in an associated withholding obligation, or*
  - *Australian dividend or interest withholding tax.*

In considering the concerns in this Alert, we will examine whether the Australian resident entity may be subject to:

- *CGT event D3 in section 104-45 of the ITAA 1997*
- *an obligation to withhold from payments to the offshore investor under Subdivision 12-F of Schedule 1 to the Taxation Administration Act 1953 (TAA)*
- *section 26-25 of the ITAA 1997 where the entity has failed to withhold from interest or royalties paid to foreign residents as required by Subdivision 12-F of Schedule 1 to the TAA.*

What are our concerns?

We are concerned that arrangements of the type considered in this Alert:

- may be deliberately structured to avoid Australian tax otherwise payable on the return to the foreign investor from the investment and/or to obtain a tax deduction for the Australian entity
- may fail to comply with interest or dividend withholding tax obligations under Subdivision 12-F of Schedule 1 to the TAA with consequential implications for denial of deductions under section 26-25 of the ITAA 1997
- may give rise to CGT event D3 under section 104-45 of the ITAA 1997
- may not be properly characterised as debt interests for the purposes of Division 974 of the ITAA 1997 and not taken into account in calculating the average value of debt capital for the purposes of the thin capitalisation provisions
- in cases where the offshore investment arrangement is treated as giving rise to debt interests under Division 974 of the ITAA 1997, that the arrangements may give rise to an equity interest and not a debt interest within the meaning of Division 974
- involve dealings following the initial investment between the offshore investor (or its associates) and the Australian entity (or its associates)
  - not being reported as related-party dealings as required in tax return schedules or reporting requirements under Division 815-E of the ITAA 1997
  - that do not reflect arm's length conditions for the purposes of determining if an entity obtained a transfer pricing benefit under Australia's transfer pricing laws in Subdivision 815-B of the ITAA 1997[4]

[4] As modified by the exceptions in subsections 815-130(2) to (4) of the ITAA 1997, where applicable.

- may be entered into or carried out for the sole, dominant or principal purpose, or for more than one principal purpose that includes a purpose of obtaining a tax benefit, or a diverted profits tax benefit, under Part IVA of the ITAA 1936
- may not satisfy the requirements to claim the benefits of a relevant tax treaty
- may also be argued to avoid a requirement to disclose to the Foreign Investment Review Board under the *Foreign Acquisitions and Takeovers Act 1975*, when an equivalent ordinary equity interest or option to acquire the asset would be required to be disclosed.

What are we doing?

We are currently reviewing these arrangements and engaging with taxpayers who have entered into, or are considering entering into, these arrangements. Our engagement and assurance activities will continue as we develop our technical position on these arrangements. Taxpayers can expect that any cases of this nature that are detected will be considered for their potential to have avoided the requirements under the *Foreign Acquisitions and Takeovers Act 1975*. Cases where this may have occurred will be referred to the Foreign Investment Review Board for further consideration.

Taxpayers and advisers who enter into these types of arrangements will be subject to increased scrutiny.

What should you do?

If you have entered, or are contemplating entering, into an arrangement of this type we encourage you to:

- phone or email us at the contact details provided below
- ask us for our view through a private ruling
- seek independent professional advice, and/or
- make a voluntary disclosure to reduce penalties that may apply.

Penalties may apply to participants in, and promoters of, this type of arrangement. This includes serious penalties under Division 290 of Schedule 1 to the TAA for promoters. Registered tax agents involved in the promotion of this type of arrangement may be referred to the Tax Practitioners Board to consider whether there has been a breach of the *Tax Agent Services Act 2009*.

Contact officer:	**Stephanie Long**
Email address:	Stephanie.Long@ato.gov.au
Telephone:	**02 9374 2040**

Commissioner of Taxation
25 May 2020

References

ATOlaw topic(s)	Income tax ~~ Assessable income ~~ Dividend income ~~ Dividend paid to non resident Income tax ~~ Assessable income ~~ Interest income ~~ Interest paid to non resident Income tax ~~ Debt equity rules ~~ Equity rules International issues ~~ Cross border financing ~~ Other International issues ~~ Non-resident Australian income ~~ Other International issues ~~ Tax havens ~~ Profit shifting International issues ~~ Transfer pricing ~~ Profit shifting International issues ~~ Treaty shopping Tax integrity measures ~~ Part IVA ~~ General anti-avoidance rules Withholding tax ~~ Other
Legislative references	ITAA 1936 6CA ITAA 1936 Pt III Div 11A ITAA 1936 Pt IVA ITAA 1997 26-25 ITAA 1997 104-45 ITAA 1997 Subdiv 815-B ITAA 1997 Subdiv 815-E ITAA 1997 815-130(2) ITAA 1997 815-130(3) ITAA 1997 815-130(4) ITAA 1997 Div 974 TAA 1953 Sch 1 Subdiv 12-F TAA 1953 Sch 1 Div 290 Tax Agent Services Act 2009 Foreign Acquisitions and Takeovers Act 1975
Other references	Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income [1983] ATS 16 Protocol Amending the Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income [2003] ATS 14
Related practice statements	PS LA 2008/15
Authorised by	Rebecca Saint, Deputy Commissioner