

Corporate Tax Essentials



Chartered Accountants
& Business Advisers

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Transfer Pricing - when is a security a debt? When it suits the Australian Tax Office

A recent ruling issued by the Australian Taxation Office (ATO) confirms that the transfer pricing rules can apply to a debt instrument that has been classified as equity under the tax debt/equity rules.

It is critical to determine whether the contribution of funds to a foreign subsidiary is debt or equity under ordinary concepts. According to the ruling, the tax debt/equity rules have no effect on the application of the transfer pricing rules, which means the Commissioner can impute interest income even when the contribution of funds is categorised as equity under the tax debt/equity rules. So what does this leave us with? Does this mean that the transfer pricing rules will only apply to a contribution of funds that is a debt in a legal form? Or is it a more flexible definition than the legal form of the debt/equity rules?

Unfortunately, this question is not addressed in this ruling. An earlier ruling issued by the ATO in 1992, however, suggests that the Commissioner can look beyond the legal character of a loan and determine whether the contribution of funds is equity or debt for transfer pricing purposes. When making his determination, the Commissioner is to take a "flexible" approach and consider all relevant factors and circumstances.

In deeming the tax debt/equity rules unsuitable for distinguishing debt from equity for the purpose of transfer pricing the ATO seems to suggest that it intends to preserve the "flexibility" afforded to the Commissioner in exercising his discretion in applying the transfer pricing rules.

This brings us back to the fundamental question – what is the distinction between debt and equity for the purpose of transfer pricing? If the tax debt/equity rules are not suitable for this purpose what guidance can taxpayers rely on? How flexible can the Commissioner be when making his determination?

The recent ruling is silent about these questions. However, it is understood that the 1992 ruling is earmarked for revision to address these issues. Until then the above questions remain unanswered. *Reference:*
TD 2008/20; TR 1992/11

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Thin Capitalisation – AIFRS transitional measures made permanent

The three-year transitional period ends soon

As the end of the three-year transitional period is fast approaching, the current government has recently issued amendments to the thin capitalisation rules. The new rules will:

- ▶ allow entities to depart from the current accounting treatment in relation to certain revaluations of intangible assets; and
- ▶ require entities to exclude Deferred Tax Assets (DTA), Deferred Tax Liabilities (DTL) and surpluses or deficits in defined benefit superannuation funds.

While there is a choice whether to include the revaluation of intangible assets, the exclusion of DTA and DTL is not optional.

However, the departure from the accounting standards will mean that entities can no longer just use the figures shown in the accounts to prepare their thin capitalisation calculations.

The following action will most likely be required to be taken in preparing thin capitalisation calculations from 1 July 2009:

1. Under Step 2: Calculating the safe harbour debt amount, BOTH the opening balance and closing balance of average assets need to be adjusted to exclude DTA's and DTL's included in the accounts (i.e. you can no longer just take the average assets amount as shown on the balance sheets);
2. Certain entities will be able to revalue and include internally generated intangible assets in their thin capitalisation calculations (which they were previously not able to do).

Note that these new rules (which are still in Bill form) apply to the income year commencing **after the date of Royal Assent of the Bill**. That means if the Bill is passed before the 30 June 2009, these rules will apply from 1 July 2009 (i.e. the 2010 year).

Potential problems addressed

The adoption of the Australian equivalents to International Financial Reporting Standards (AIFRS) in 2005 put many entities at risk of breaching the thin capitalisation rules. The risk was mainly associated with the write-down of intangible assets as required by AIFRS. For many entities, the write-down or derecognition of intangible assets significantly reduced the safe harbour amount, which in turn increased the risk of having a proportion of the entity's debt deductions denied.

To address such undue disadvantage caused by the adoption of AIFRS, the Howard government granted a three-year transitional period in which entities were allowed to continue to apply the old accounting standards for the purposes of the safe harbour amount calculation.

Reference: Tax Laws Amendment (2008 Measures No. 5) Bill 2008

Dead companies can come back to life

Deregistration is not the end

Deregistration is not necessarily the end of a company as the Corporations Act gives the Courts a wide discretion to order ASIC to reinstate a deregistered company.

In a recent case before the Federal Court, the Commissioner of Taxation successfully obtained a court order to reinstate the registration of James Hardie Australia Finance Pty Ltd (JHAF). The reinstatement of JHAF will allow the ATO to commence a liquidator's investigation into a possible tax avoidance scheme which involves a tax liability and penalties of approximately \$240m.

This case suggested that a series of steps were adopted by JHAF (and its only two shareholders, both are companies within the James Hardie group) to strip the company of its assets. The methods used to "denude" JHAF's assets were dividend payments and capital reductions over a number of years. After JHAF's share capital was reduced to around \$1,000, the company appointed a liquidator for a members' voluntary winding-up and deregistration.

The Court order to reinstate the company's registration will mean that the Commissioner is now able to appoint a liquidator to further investigate the capital reductions that occurred prior to the deregistration of JHAF. The investigation will determine who (the directors and/or the shareholders) is liable for the tax debt.

Voluntary liquidation provides little protection

The outcome of this case is a reminder that liquidating and deregistering a company voluntarily does not necessarily provide protection for the directors and shareholders. The only way to be certain that creditors will not come after you after the deregistration is to ensure that the company is wound up in good faith and that no creditor is aggrieved by the deregistration of the company.

Further, it is vital for the company in liquidation to settle all tax liabilities and obtain a tax clearance certificate from the ATO as part of the winding-up process.

Reference: Deputy Commissioner of Taxation; in the matter of James Hardie Australia Finance Pty Ltd (Deregistered) [2008] FCA 1181

Limitation to CGT exemption for foreign business assets

Subject to certain rules, a capital gain or loss incurred by an Australian company from a disposal of interest in an active foreign company may be reduced by the foreign company's "active foreign business asset percentage".

The ATO has confirmed that the active assets of a partnership in which the foreign company is a partner are not active assets for the foreign company.

By excluding active assets of a partnership, the active foreign business asset percentage may be reduced which in turn may increase the capital gains tax on the disposal of eligible shares in a foreign company.

Reference: TD 2008/23,

No exemption for non-portfolio foreign dividends

Subject to certain rules, a non-portfolio dividend received by an Australian company from a foreign country is not taxable in Australia. A non-portfolio dividend is a dividend from a foreign company in which the Australian holding company has more than 10% voting power.

However, the ATO has confirmed in a recent determination that a non-portfolio dividend will not qualify for the favourable tax treatment if it is received by the Australian company in a capacity of a partner in a partnership unless the partnership is part of a tax consolidated group or a multiple entry consolidated (MEC) group. This is the case even if the partnership is a corporate limited partnership.

The ATO has also stated in a separate determination that the non-portfolio dividend will also not qualify for the favourable tax treatment if it is received by a company in the capacity of a trustee even if the dividend is then distributed to an Australian resident company beneficiary. However, the tax exemption will apply to a non-portfolio dividend paid to a trust that is part of a tax consolidated group or multiple entry consolidated (MEC) group.

Reference: TD 2008/24 and TD 2008/25

Should you require assistance additional information, **contact your PKF tax adviser** or:

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