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# ***Australia: Revised draft determination released on deductibility of support payments to subsidiaries***

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## ***In brief***

The Australian Taxation Office (ATO) has released a revised draft Taxation Determination TD 2014/D7 outlining its views on whether certain payments described in the ruling as capital support payments made by an Australian parent company to its subsidiary are deductible. TD 2014/D7 is relevant to any Australian company that makes intra-group payments to a subsidiary company located outside of Australia.

This draft tax determination (the revised draft TD) contains substantial revisions to the original draft Taxation Determination TD 2013/D3, which was released by the ATO in April 2013. The revised draft TD now includes specific reference to Australia transfer pricing rules and a range of additional examples that differentiate arrangements that may be capital in nature or deductible. A copy of the revised draft TD is available on the [ATO website](#).

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## ***In detail***

The view expressed in the revised draft TD is that 'capital support payments' made by an Australian parent entity to a subsidiary are capital in nature for the purposes of paragraph 8-1(2)(a) of the *Income Tax Assessment Act 1997* (ITAA 1997), are not a loss from a financial arrangement and accordingly are not deductible under subsections 230-15(2) or 230-15(3) and that such payments are included in the cost base and reduced cost base

of the parent's investment in the subsidiary and are therefore not deductible under section 40-880 of the ITAA 1997.

Consistent with the original draft Tax Determination, the revised draft TD applies specifically to arrangements between a parent entity and its subsidiary entity (as these terms are defined in section 46 of the *Corporations Act 2001*), with an investment by a parent entity in a subsidiary including both a direct and an indirect investment.

Following a public consultation process, the revised draft TD contemplates a much narrower set of circumstances under which a 'capital support payment' can arise than was previously the case under the original draft Tax Determination. The revised draft TD now clarifies that where the payment has the character of any of the following then it will not be a capital support payment:

- 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.
- A loan to the subsidiary or the repayment of such a loan.

This applies on the basis that the parent's obligation to provide assets or services is not insignificant compared with the rights and obligations of the arrangement. The extent to which the parent's obligations are 'not insignificant' is not explored in the revised draft TD.

Importantly, in relation to a price adjustment:

- It must be possible to identify the particular asset or service, or group of assets or services which requires re-pricing.
- A payment cannot have the character of a reduction in the price of something where no price is payable.
- A payment cannot have the character of a reduction in the price of something to the extent that it exceeds that price.

This is a welcome revision and provides taxpayers with additional clarity in relation to the circumstances in which the ATO considers a support payment to be capital in nature. The revised draft TD also contains six example scenarios, demonstrating that payments can be deductible under section 8-1 where they are not made merely because the subsidiary has made a loss or was not sufficiently profitable. Specific scenarios where the payment is considered deductible include:

- Where the payment made by the parent is to reimburse its subsidiary for the excess advertising and promotion expenditure the subsidiary incurred above that which an independent distributor would have incurred in comparable circumstances.
- Where the payment is characterised as an adjustment to the price of goods sold by the parent to its subsidiary.
- Where the payment is characterised as a payment for services provided by the subsidiary to the parent in the subsidiary's undertaking of a market penetration strategy. Importantly, a distinction is made between an entity that performs work or other beneficial acts for its parent compared with those that merely conduct a business on its own account and for its own benefit.

Regrettably, it is still indicated that the TD will apply retrospectively. While it will not apply to taxpayers where it conflicts with the terms of a settlement of a dispute, clarity of what this could mean for taxpayers with an Advance Pricing Agreement is not provided.

#### ***PwC's observations***

- The revised draft TD represents a significant improvement on the previous draft in terms of clarity of scope and application. Nevertheless the draft TD appears to continue to apply a narrow set of circumstances to arrive at a conclusion that support payments are capital in nature.

- While the notion of objectivity is required in determining the purpose of the payments, it remains unclear from the comments and relatively simple examples provided how this will be considered by the Commissioner. Importantly, the onus will fall on taxpayers to demonstrate, through an analysis of the relevant facts and circumstances, that objectively its payments reflect the exceptions and therefore are not capital support payments.
- Documenting the underlying facts and circumstances of the arrangements, including assumption of risks and provision of services in inter-company agreements and supporting transfer pricing analysis will be critical in developing a supportable position for deductible support payments.
- There is an apparent focus on the extent to which support payments reconstitute subsidiary losses (determined to be capital in nature) compared with deductible payments designed to achieve an arm's length return through an appropriate transfer pricing method (such as the transactional net margin method). Further, based on a comparison of examples one and six provided, the assignment of risk between the parties and consequent characterisation of the subsidiaries as 'at risk' compared with 'limited risk' also appears to influence the Commissioners view.
- Customs impacts may apply where the payment is

characterised as a product pricing adjustment.

- There appears to be a presumption that support arrangements will be temporary. Specific examples where deductibility of payments is supported reflects specific penetration strategies or temporary shortfalls of expected subsidiary results. The extent to which the Commissioner would allow such arrangements to continue, or alternately recognition of ongoing market representation are not specifically contemplated. While market representation arrangements might fall within the category of service arrangements, we hope this will be clarified in the final

ruling to ensure symmetry of treatment with inbound arrangements.

- In this regard additional clarity is required regarding what constitutes a service. We consider the existing OECD and ATO guidance on intra-group service transfer pricing should provide a useful starting point for further analysis.

### ***The takeaway***

#### ***What should you do?***

In our view whether a support payment made by a parent to its subsidiary is capital or revenue in nature will depend on an analysis of the specific facts and circumstances of the case. Based on the revised draft TD, there are a range of circumstances where support payments can be

treated as deductible, however care is still needed in ensuring that the arrangements are arm's length and appropriate and detailed supporting documentation may be required. The revised draft TD highlights the importance of having accurate and up to date inter-company agreements in place with the economic substance of the arrangements matching the documented legal form.

If the draft determination is finalised, taxpayers will need to consider the Commissioner's view and this might involve ensuring that a reasonably arguable position on the deductibility of the payments is documented. The ATO has invited comments on the revised draft TD to be provided by 28 February 2014.

### ***Let's talk***

For more information, please contact:

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