



Guide to the debt and equity tests

How to determine whether an interest is a debt interest or equity interest under the debt and equity rules.

Last updated 16 April 2018

This guide outlines the broad operation of the debt/equity rules in Division 974 of the *Income Tax Assessment Act 1997*. The debt/equity rules determine whether an interest is a debt interest or an equity interest.

The guide is divided into two parts:

[Part A](#) – Explains the debt and equity tests, including how to work out if an interest is to be treated as debt or equity, how to use the debt test to identify debt for thin capitalisation purposes and how the transitional rules operate.

[Part B](#) – Provides examples of how to apply the tests in various situations.

Some of the terms used in the guide may be new to you. They are explained in paragraphs throughout the guide when first used.

Part A: Explaining the tests for debt and equity interests



The debt and equity rules determine what is equity in a company and what is debt in an entity for tax purposes.

Part B: Applying the tests for debt and equity interests



The debt and equity rules determine whether distributions may be frankable (equity) or deductible (debt) to the entity making the distribution.

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Part A: Explaining the tests for debt and equity interests

The debt and equity rules determine what is equity in a company and what is debt in an entity for tax purposes.

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Tests for debt and equity

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The tests for debt and equity interests are found in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997). Division 974 tells you whether a particular arrangement gives rise to a debt interest or an equity interest. The debt or equity classification of an interest is relevant for certain tax purposes. The debt and equity tests determine whether a return on an interest in an entity may be frankable and non-

deductible (like a dividend) or may be deductible to the entity and not frankable (like interest). Also, being classified as a debt interest can affect what is a membership interest for the purposes of the consolidation measures, and is a key element in applying the thin capitalisation measures. And whether an interest is a debt or equity interest is relevant in determining whether certain returns may be subject to interest withholding tax or dividend withholding tax.

In determining what's a debt interest, the rules use a single organising principle – the effective obligation of an issuer to return to the holder an amount at least equal to the amount invested. (If a debt interest involves money being lent in return for a promise to repay the loan with interest, the 'issuer' of the debt interest receives the loan funds and issues the debt interest and the 'holder' of the debt interest lends the funds and receives the debt interest.) The rules have regard to the substance of the arrangement, and the classification is not necessarily determined just by the legal form of the arrangement.

There is a tiebreaker test that applies to interests that pass both the debt and equity tests. Where both the debt and equity tests are satisfied, the tiebreaker test provides that the interest is a debt interest.

As for equity interests, the rules contain a table that lists four categories of arrangements which give rise to equity interests, subject to them not also passing the debt test, in which case the tiebreaker rule will apply.

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Determining whether an interest is a debt interest

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Fourth element – the issuing entity must have an effectively non-contingent obligation to provide a future financial benefit

Fifth element – it must be substantially more likely than not that the value of the financial benefit to be provided will be at least equal to or exceed the financial benefit received

The debt test is set out in **Subdivision 974-B** of the *Income Tax Assessment Act 1997*. The following flowchart shows the basic test for working out if an interest is treated as debt at the time it is issued. (For ease of exposition, the basic test outlined here does not address more complex situations where two or more entities, or '[connected entities](#)', or two or more [related schemes](#) are involved).

The flowchart shows that five essential elements are required to satisfy the debt test:

1. There must be a scheme.
2. The scheme must be a financing arrangement.
3. There must be a financial benefit received.
4. The issuing entity must have an effectively non-contingent obligation to provide a future financial benefit, and
5. It must be substantially more likely than not that the value of the financial benefit to be provided will be at least equal to or exceed the financial benefit received.

First element – there must be a scheme

The first element of the debt test that must be satisfied for the interest to be classified as debt is the existence of a scheme. A scheme is defined in section 995-1 of the *Income Tax Assessment Act 1997*.

- **Scheme** means any arrangement, or any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

Second element – the scheme must be a financing arrangement

The second element of the debt test that must be satisfied for the interest to be classified as a debt interest is the existence of a financing arrangement.

- A **financing arrangement** an arrangement entered into by the issuer to raise finance or to fund another scheme that is a financing arrangement, or to fund the return on another scheme that is a financing arrangement

A financing arrangement generally involves the contribution to an entity of capital in some form. For example, a basic financing arrangement would involve the provision of loan capital to an entity in return for the issue of a debt interest.

Certain arrangements, such as ordinary employment contracts, are generally not undertaken to raise finance, and so such arrangements will neither be debt nor equity interests. Some things are specifically excluded from being financing arrangements, for example, life insurance and general insurance contracts undertaken as part of the issuer's ordinary course of business.

Third element – there must be a financial benefit received

The third element of the debt test that must be satisfied for the interest to be classified as a debt interest is the receipt of a financial benefit by the issuing entity under the financing arrangement.

- A **financial benefit** is defined as anything of economic value. It includes property and services.

Generally, the financial benefit received will be the issue price specified in the terms of the financing arrangement. It is the amount paid to acquire the financial interest. Amounts may also be receivable in the future.

Fourth element – the issuing entity must have an effectively non-contingent

obligation to provide a future financial benefit

For an interest to be regarded as a debt interest, there must also exist an effectively non-contingent obligation for the issuer to provide a financial benefit to the holder of the interest. The financial benefit to be provided could be a single amount, or involve a number of instalments over time.

To determine whether an effectively non-contingent obligation exists, regard is to be had to the terms, conditions and pricing of the financing arrangement.

This fourth element of the debt test uses the concept of an obligation that is non-contingent in substance – as opposed to an obligation that is non-contingent only in form.

Where a creditor has a right that becomes due and payable, the debtor's inability or unwillingness to meet the obligation does not make the obligation contingent.

Where more than one entity has an effectively non-contingent obligation to provide a financial benefit in respect of one issue, there are rules for working out which entity is taken to have issued the interest.

In some cases involving obligations owed by a number of entities under a scheme, the Commissioner of Taxation has the power to determine who issued the debt interest.

In considering whether there is an effectively non-contingent obligation, artificial and immaterially remote contingencies are to be ignored.

Subordination

Subordination clauses that preserve the obligation, and operate to merely postpone enforcement of that obligation to a time that other creditors are paid, do not prevent there being a non-contingent obligation. This may result in the performance of the obligation not occurring, because senior creditors may never be paid in full. Nevertheless, if ultimately the subordinated claim may receive less than the full amount owing only because the debtor has insufficient assets to repay both the senior creditor and the subordinated claim in

full, then meeting the obligation is dependent only on the debtor's ability to pay and this is not enough to make the obligation contingent.

However, where the creditor's right to repayment is subordinated to the level of ordinary equity interests, such that the obligation to, in a winding up, repay the creditor is contingent on paying the ordinary equity interest holders, the obligation will be contingent.

Limited recourse loans

In a limited recourse loan arrangement, if the borrower does not repay the amount due at maturity, the lender's only recourse is to a specified security or asset. This limitation of recourse will not of itself prevent the debtor having an effectively non-contingent obligation to provide a financial benefit. Where there is an effectively non-contingent obligation, whether the interest passes the debt test will fall to be determined by whether it is substantially more likely than not that the value of the security or asset to be provided will be at least equal to, or exceed, the amount borrowed.

However, limited recourse loan arrangements can be drafted in a number of ways. If the drafting is such that the obligation ceases to exist, or never comes into existence, that would bring the existence of a debt interest into real question. In such a case, it is necessary to look at the limited recourse loan arrangement as a whole, including considering whether any associated security arrangements give rise to an effectively non-contingent obligation.

Where, in a secured loan, in order to prevent potential problems with insolvent trading, the personal obligation of the debtor is made legally contingent on whether there are sufficient assets to meet the obligation, the personal obligation of the debtor will be contingent. If, however, the right of the secured creditor to proceed against the property constituting the security remains unconstrained, the obligation of the debtor to suffer the creditor to proceed in that way against the security will itself be an effectively non-contingent obligation to provide a financial benefit to the creditor in the form of the security. Provided the amount of the secured indebtedness is not itself affected by the contingency to which the personal obligation is subject, the result will ordinarily be that the security agreement has created an effectively non-contingent obligation in respect of the security.

Fifth element – it must be substantially more likely than not that the value of the financial benefit to be provided will be at least equal to or exceed the financial benefit received

If the issuer has an effectively non-contingent obligation, the fifth element of the debt test requires that it be substantially more likely than not that the financial benefit to be provided by the issuer will be at least equal to the value of the financial benefit received.

- The **financial benefit to be provided** is what the issuer has an effectively non-contingent obligation to provide to the investor in relation to the interest. This can include the return of the initial investment amount.

The method of calculating the value of the financial benefit depends on the performance period of the arrangement. If the term is 10 years or less, the value will be calculated in nominal terms. If the term is more or may be more than 10 years, the value of the benefit will be calculated in present value terms.

- The **performance period** is the period within which, under the terms on which the interest is issued, the issuer has to meet its effectively non-contingent obligations in relation to the interest.

An obligation is treated as having to be met within 10 years of the interest being issued if the terms formally exceed 10 years but there is an effectively non-contingent obligation to terminate the interest within 10 years.

- The **present value** of a benefit is the nominal value of the benefit, discounted using the adjusted benchmark rate of return.
- The **adjusted benchmark rate of return** is defined as 75% of the benchmark rate of return on the test interest.
- The **benchmark rate of return** is defined as the internal rate of return on an investment if the investment were 'ordinary debt' of the issuer or an equivalent entity, compounded annually and otherwise comparable with the interest under consideration.

Where an instrument is perpetual it is mathematically impossible to apply the present value calculation formula in subsection 974-50(4)

literally. Accordingly, where the value or the amount of the financial benefit on the perpetual instrument is the same for each year, the total value of the benefit on a present value basis can be approximated as:

amount or value of financial benefit in nominal terms / adjusted benchmark rate of return.

Because the number of returns on the perpetual instrument is indefinite, this approximation is a reasonable and intended application of the present value formula in subsection 974-50(4). It results in an appropriate reflection of a present value of a financial benefit provided on the perpetual instrument.

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Commissioner's power

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Where an arrangement involves, broadly:

- an effectively non contingent obligation to provide a financial benefit which equals a substantial part of the financial benefit received
- the provision of contingent, but likely, financial benefits that, when combined with the effectively non contingent payments, are expected to equal or exceed the financial benefit received
- the Commissioner can determine that the arrangement gives rise to a debt interest.

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Determining whether an interest is an equity interest

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[Item 4 – an interest issued by the company that will or may convert to, or provides a right to be issued with, an equity interest in the company](#)

The equity test is set out in Subdivision 974-C of the *Income Tax Assessment Act 1997*. The equity test identifies those financing arrangements issued by a company that may have frankable distributions (like dividends) rather than having returns that may be deductible (like interest). The law contains a table that lists schemes that are equity interests. A scheme satisfies the equity test if it gives rise to an interest listed at items 1 to 4 of this table. In relation to items 2 to 4 of the table, the interest must also be a [financing arrangement](#).

A scheme gives rise to an equity interest if the scheme satisfies the equity test when it comes into existence, subject to it also satisfying the debt test. (Under a tiebreaker rule, if a scheme satisfies both the debt test and the equity test, it will be a debt interest.). Unless an interest satisfies the debt test at the time of issue, entities will issue an equity interest when they issue:

- a membership interest (such as a share) [item 1]
- an interest providing returns that depend on the issuer's economic performance [item 2]
- an interest providing returns at the discretion of the issuer [item 3], or
- an interest that may or will convert into such an interest or share [item 4].

In this context returns include a return of an amount invested in the interest.

Item 1 – an interest as member or stockholder of the company

Unless it satisfies the debt test, any membership interest in a company is an equity interest in that company, whether an ordinary share or a preference share, and whether in a company limited by shares or a company limited by guarantee.

Item 2 – an interest that carries a right to a return that is effectively contingent on economic performance

Item 2 of the table recognises an equity interest where the holder of such an interest has a right to a return that is dependent on the economic performance of the company or certain activities of the company. An example of this would be an interest where the returns are dependent on the company's profits.

An equity interest does not generally arise in cases where an employee's remuneration is partly or wholly contingent on the economic performance of a company. This is because a contract for personal services entered into in the ordinary course of the business of an entity is generally not entered into to raise finance.

Item 3 – an interest that carries a right to a return that is at the discretion of the company

Item 3 of the table recognises an equity interest where the holder of such an interest has a right to a return that is made at the discretion of the company. An investor may, for example, have an interest in an entity that provides a return of a set amount unless the directors determine otherwise: the interest is an equity interest.

Item 4 – an interest issued by the company that will or may convert to, or provides a right to be issued with, an equity interest in the company

A holder of an interest issued by the company that carries a right to be issued with an equity interest in the company holds an equity interest in the company. Similarly, an investor holds an equity interest if the interest they hold is issued by the company, and it will or may convert into an equity interest in the company.

Note that an interest which may convert into an equity interest in a company which is not issued by the company or a [connected entity](#) of the company will not be an equity interest in the company. For example, if an entity issues an option which gives the holder a right to acquire a share in a company which is unrelated to the issuing entity, that option is not an equity interest in the company. (Of course, if the option is exercised and the option holder becomes a shareholder of the company, the share will be an equity interest in that company.)

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Related scheme rules

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The debt and equity test provisions have rules which can, under certain circumstances, aggregate a number of schemes and treat that aggregated scheme as a debt interest or an equity interest. These rules are the 'related scheme' rules.

There is also a rule which, in certain circumstances, allows a single scheme to be treated as two or more separate schemes.

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Non-share equity interest

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An equity interest in a company that is not in legal form solely a share in the capital of the company or stock in the company, is called a non-

share equity interest. The definition of equity interest and related concepts of equity holder and non-share dividend are used in the imputation provisions of the income tax law. Both shareholders and holders of non-share equity interests may be paid frankable dividends by the entity.

To be a non-share equity interest it is necessary for the whole interest, or a part of it, to be in a form other than a share. Therefore, if an equity interest in a company is made up of related interests and at least one of those interests is not a share, the interest is a non-share equity interest.

Capital raised by a company from the issue of non-share equity interests is credited to a non-share capital account.

A company has a **non-share capital account** if the company issues a non-share equity interest in the company on or after 1 July 2001, or the company has issued a non-share equity interest in the company before 1 July 2001 that was still in existence on 1 July 2001.

Keeping a non-share capital account

If a company issues a non-share equity interest in the company, the company has a notional account called a non-share capital account. The account records contributions to the company in respect of those non-share equity interests and returns by the company of those contributions. A distribution on a non-share equity interest can be characterised as either a non-share dividend or a non-share capital return. Specifically, non-share distributions that are debited against the notional account are non-share capital returns.

Sections 164–15 and 164–20 of the *Income Tax Assessment Act 1997* specify the credits and debits that may be made to the non-share capital account.

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Connected entities

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The debt/equity provisions also include the concept of connected entities.

- A **connected entity** of an entity is either an associate of the entity or another member of the same wholly owned group if the entity is a company and is a member of that group.

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Small business turnover carveout for at call loans between connected entities

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If a company has a turnover of less than \$20 million, there is a carve-out which means that related party 'at call' loans will be treated as being debt interests rather than equity interests.

A company's annual turnover (worked out at the end of an income year) is to be determined in accordance with subsection 188-10(2) of the *Goods and Services Tax (GST) Act 1999*. This test is already used by small companies for GST purposes.

Private companies with related party 'at call' loans that do not qualify for debt treatment may change their loans so they are debt interests under the debt/equity rules. Taxpayers may elect to treat this change as if it occurred at the beginning of the previous income year. This election must be made before the earlier of the due date for the company's tax return or the date of actual lodgment for that year.

Because the turnover test applies on an annual basis, a company may qualify for deemed debt treatment under the debt/equity rules for one year but not the next. This means that related party 'at call' loans to the company could change from being debt interests to being equity interests if their turnover exceeds \$20 million.

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Thin capitalisation and the debt and equity tests

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The debt test is also used to identify which financing arrangements constitute debt for thin capitalisation purposes. Amounts outstanding on debt interests issued by an entity that are still on issue will constitute 'debt capital' under the thin capitalisation rules. Broadly, if the thin capitalisation rules apply, an entity is required to calculate its debt capital and compare it to its maximum allowable debt. If the entity's debt capital is more than its maximum allowable debt the entity's debt deductions may be denied to that extent. Therefore, it is important for thin capitalisation purposes to identify whether an interest is a debt interest.

Further, it is also necessary for thin capitalisation purposes to identify whether an interest which an entity holds in another entity is an equity interest. In addition to the equity interest rules discussed above, special rules are included in the thin capitalisation law which determine whether an interest is an equity interest in a partnership or trust.

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Provisions relating to international taxation

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Withholding tax

The debt/equity rules will apply to Division 11A of Part III of the *Income Tax Assessment Act 1936* except where the sections relate to levels of

ownership. Therefore, apart from these sections, the Division will apply to a non-share dividend in the same way as it applies to a dividend.

Division 11A imposes a withholding tax on Australian sourced dividends, interest and royalties paid to non-residents. For the purpose of determining the boundary between interest and dividend withholding tax, interest withholding tax may apply to a non-equity share rather than dividend withholding tax. To the extent to which an amount is a return on an equity interest, interest withholding tax will not apply.

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Public trading trusts and corporate unit trusts

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Certain unit trusts are taxed in an equivalent way to companies. There are public trading trusts and corporate unit trusts identified in Division 6C of Part III of the *Income Tax Assessment Act 1936*. The new debt/equity rules will apply in relation to these trusts in an equivalent way to how they apply to companies.

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Part B: Applying the tests for debt and equity interests

The debt and equity rules determine whether distributions may be frankable (equity) or deductible (debt) to the entity making the distribution.

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Redeemable preference shares



Converting preference shares



Convertible notes



Connected entity at call loan



Non-share capital account



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Redeemable preference shares

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Example:

A company issues redeemable preference shares on 15 August 2010 with a face value of \$2 each. These shares will be redeemed for their face value after eight years, or earlier if a takeover offer is made and accepted by the board of the company. Dividends will be paid annually at 7.25% of the issue price at the same time as dividends on ordinary shares are paid. The company is not permitted to pay a dividend on its ordinary shares unless and until all arrears of dividends on the redeemable preference shares have been paid.

The following steps determine if it is an equity interest

Equity test step 1: is the interest an equity interest?

As the interest is in the form of a share, it is an equity interest unless it is a debt interest.

Debt test step 1: is there a scheme?

There is a scheme in the form of an arrangement between the issuing company and the holder.

Debt test step 2: is the scheme a financing arrangement?

The contract in respect of redeemable preference shares is a scheme that is an arrangement entered into to raise finance for the entity.

Debt test step 3: does the issuing entity receive a financial benefit under the arrangement?

The issuing company receives a financial benefit under the arrangement. The value of the benefit is the price the holder paid for the preference shares – namely, \$2.

Debt test step 4: does the issuing entity have an effectively non-contingent obligation to provide a financial benefit?

The issuing company does not have an effectively non-contingent obligation to pay an annual dividend because the payment of the dividends is contingent upon the availability of profits of the issuer. However, the issuing company has an effectively non-contingent obligation to repay the issue price on redemption.

Debt test step 5: is it substantially more likely than not that the financial benefit to be provided will be at least equal to or exceed the financial benefit received?

The valuation of the benefits is to be in nominal terms because the performance period is within 10 years. The value of the benefit received by the company at issue date is the price of the security – namely, \$2. The value of the financial benefit to be provided under the scheme is the return of the principal amount of \$2.

The \$2 future financial benefit provided by the company is equal to the \$2 it received, so the interest meets the debt test.

Tiebreaker rule

The interest meets both the equity and the debt tests. Therefore, it is characterised as debt.

Converting preference shares

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Example

A bank issues converting preference shares on 1 July 2011 at an issue price of \$100 each. The shares pay annual dividends of 7.5%. Conversion is mandatory on 30 June 2016.

The following step determines if it is an equity interest.

Equity test step 1: is the interest an equity interest?

As the interest is in the form of a share, it is an equity interest unless it is a debt interest.

The following steps determine if it is a debt interest.

Debt test step 1: is there a scheme?

There is a scheme in the form of an arrangement between the bank and the holder.

Debt test step 2: is the scheme a financing arrangement?

The contract in respect of converting preference shares is an arrangement entered into to raise finance for the bank.

Debt test step 3: does the issuing entity receive a financial benefit under the arrangement?

The bank receives a financial benefit under the arrangement. The value of the benefit received is the \$100 issue price.

Debt test step 4: does the issuing entity have an effectively non-contingent obligation to provide a financial benefit?

The bank does not have an effectively noncontingent obligation to provide a future financial benefit because the payment of dividends is

contingent on the profit of the bank and the value of the shares on conversion is disregarded. This condition is not satisfied. The interest is not treated as a debt interest. Accordingly, the interest is an equity interest.

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Convertible notes

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Example:

A company issues 15 year convertible notes on 1 July 2010 for \$9 each. The notes have coupons of 7% paid annually on 1 July. The obligation to pay the coupons is not subject to any contingency and cannot be deferred or waived in any circumstance. At any time after 1 July 2016, the company can terminate the arrangement early. However, on either early termination or at the original maturity date (1 July 2025), the noteholders have the option to either have the notes redeemed for \$9 or converted into shares at a ratio of four shares per note. The shares are currently trading at \$1.75. The company's ordinary debt rate is 8%.

The following steps determine if it is an equity interest

Equity test step 1: is the interest an equity interest?

The interest is an equity interest because it gives the holder the right to be issued with an equity interest in the issuer. Alternatively, the interest is an equity interest because it may convert into an equity interest in the company.

Equity test step 2: is there a scheme?

There is a scheme in the form of an arrangement between the company issuing the notes and the holder.

Equity test step 3: is there a financing arrangement?

The contract in respect of convertible notes is an arrangement entered into to raise finance for the company.

The interest is an equity interest unless it is a debt interest.

The following steps determine if it is a debt interest.

Debt test step 1: is there a scheme?

There is a scheme. See step 2 above.

Debt test step 2: is the scheme a financing arrangement?

The scheme is a financing arrangement. See step 3 above.

Debt test step 3: does the issuing entity receive a financial benefit under the arrangement?

The issuing company receives a financial benefit under the arrangement, being the issue price of the convertible note – namely, \$9.

Debt test step 4: does the issuing entity have an effectively non-contingent obligation to provide a financial benefit?

The issuing company has an effectively non-contingent obligation to pay 7% for the term of the note to the note holder. The company also has an obligation to repay the investment of \$9 at maturity or earlier termination, provided that the note holder does not exercise its right to convert the note into shares. A right of this sort does not of itself make the obligation to repay the investment contingent. In this case, it is considered that the obligation to repay the investment is an effectively noncontingent obligation.

Debt test step 5: is it substantially more likely than not that the financial benefit to be provided will be at least equal to or exceed the financial benefit received?

The performance period is more than 10 years because, although there is an option to redeem at the end of six years, there is no effectively non-contingent obligation to do so. Therefore, the valuation of the benefits is calculated in present value terms.

The value of the financial benefit in present value terms is:

$$\frac{\text{Amount or value of financial benefit in nominal terms}}{[1 + \text{Adjusted benchmark rate of return}]^n}$$

The value of the financial benefit received by the issuer at issue date is the issue price of \$9. The value of the financial benefit to be provided by the company in relation to each note is calculated as follows:

- the coupon amount per coupon period is \$0.63 ($\$9 \times 7\%$)
- the adjusted benchmark rate of return is 6% ($8\% \times 75\%$), or 0.06, and
- using the present value calculation method, the value of the financial benefit to be provided by the company is \$9.87.
- $0.63/(1.06)^1 + 0.63/(1.06)^2 \dots + (9 + 0.63)/(1.06)^{15}$

The value of the financial benefit to be provided by the company of \$9.87 is more than the value of the benefit it received of \$9, so the interest is a debt interest.

Tiebreaker rule

The interest meets both the equity and the debt tests. Therefore, it is characterised as debt.

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Connected entity at call loan

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Example

A company borrows \$5,000,000 from a controlling shareholder (a [connected entity](#)). The terms and conditions of the loan provide that interest is payable on the principal sum at the rate of 7% per annum. The loan does not have a specified repayment date and the lender may call for the funds to be repaid at its absolute discretion. The company does not meet the [small business turnover carve-out test](#).

Assume the [benchmark rate of return](#) for the company is 6% per annum.

The following steps determine if the loan is an equity interest

Equity test step 1: is the interest an equity interest?

The interest is an equity interest because the amount of the overall return in the interest is at the discretion of the connected entity (item 3 of the table in subsection 974-75(1) of the *Income Tax Assessment Act 1997*).

Equity test step 2: is there a scheme?

There is a scheme in the form of an arrangement between the company and the connected entity.

Equity test step 3: is there a financing arrangement?

The agreement is an arrangement entered into to raise finance for the company.

The interest is an equity interest unless it is a debt interest.

The following steps determine if it is a debt interest.

Debt test step 1: is there a scheme?

There is a scheme. See step 2 above.

Debt test step 2: is the scheme a financing arrangement?

The scheme is a financing arrangement. See step 3 above.

Debt test step 3: does the company receive a financial benefit under the arrangement?

The company receives a financial benefit under the arrangement, being the \$5,000,000 it borrowed from a connected entity.

Debt test step 4: does the company have an effectively non-contingent obligation to provide a financial benefit?

The company has an effectively non-contingent obligation to pay 7% per annum.

Debt test step 5: is it substantially more likely than not that the financial benefit to be provided will be at least equal to or exceed the financial benefit received?

The performance period is more than 10 years because, although there is a possibility that repayment of the loan may be demanded at any time, there is no effectively non-contingent obligation to repay within 10 years. Therefore, the valuation of

the benefits is calculated in present value terms (section 974–50 of the *ITAA 1997*).

The value of the financial benefits is calculated using the prescribed present value formula:

$$\frac{\text{Amount or value of financial benefit in nominal terms}}{[1 + \text{Adjusted benchmark rate of return}]^n}$$

The [adjusted benchmark rate](#) of return is 4.5% (that is, 6% x 75%).

The amount of each interest financial benefit to be provided by the company is as follows:

Loan amount (\$5,000,000) x interest rate payable (7% per annum) = \$350,000

Using the present value calculation method, the value of the interest financial benefits to be provided in perpetuity is approximately \$7,777,777.

The value of the financial benefits (approximately \$7,777,777) that are to be provided by the company is more than the value of the financial benefit of \$5,000,000 that it received, so the interest is a debt interest.

Tiebreaker rule

The interest meets both the equity and the debt tests. Therefore, it is characterised as a debt interest.

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Non-share capital account

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[Primary legislative references](#)


Example

Assume a controlling shareholder has made an undocumented \$50,000 [connected entity](#) 'at call loan' to a company on 1 July 1997, on the understanding that interest may be paid on the loan from time to time. The company's annual turnover exceeds the maximum allowable under the [small business carve-out test](#), and the loan is a [non-share equity interest](#) of the company (for an explanation of the application of the debt/equity rules to connected entity at call loans, refer to the [guide to 'at call loans'](#)).

The company has a non-share capital account. It will be credited with the value of the at call loan to account for the equity interest. Its non-share capital account will be debited with the amount of any repayments the company makes after 1 July 2005.

Assume the company repays \$10,000 to the shareholder on 1 January 2006. It will debit its non-share capital account for \$10,000.

The transactions above are illustrated in the following non-share capital account:

 Non share capital account

Primary legislative references

- Division 974 of the *Income Tax Assessment Act 1997*

What next?

- Visit the [Debt and equity tests homepage](#)

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