# Chapter 1
# Amendments to the limited recourse debt provisions

## Outline of chapter

1.1 Schedule # of this exposure draft amends Division 243 of the *Income Tax Assessment Act 1997* (ITAA 1997) (the limited recourse debt provisions) to clarify that the definition of limited recourse debt includes arrangements where, in substance or effect, the debtor is not fully at risk in relation to the debt.

1.2 Under such arrangements, the creditor's rights as against the debtor, in the event of default in payment of the debt, are in substance or effect limited, wholly or predominantly, to rights in relation to certain assets.

1.3 All references to legislative provisions in this chapter are references to the ITAA 1997 unless otherwise stated.

## Context of amendments

1.4 The purpose of the limited recourse debt tax provisions is to recoup excess capital allowance deductions claimed with respect to capital expenditure where the taxpayer has not been fully at risk in relation to the expenditure because it is financed by a limited recourse debt and has not fully repaid the debt upon termination.

1.5 The provisions operate to reverse capital allowance deductions that, at the time the debt is terminated, are excessive having regard to the amount of the debt repaid.

1.6 Limited recourse debt refers to financing arrangements where the creditor's rights of recourse, upon the debtor's default in payment of the debt, are wholly or predominantly limited to rights in respect of specific assets.

1.7 Creditor's rights to recourse can be limited by contractual terms or by arrangements, such as an arrangement involving the use of a special

purpose entity as the debtor which predominantly holds and operates the financed assets. In both situations, the debtor is not fully at risk with respect to the debt and therefore the capital expenditure which is financed by the debt.

1.8 The current definition of ‘limited recourse debt’ in section 243-20 is intended to include contractually limited recourse debt arrangements as well as debt arrangements where recourse is effectively limited through arrangements.

1.9 That is, Division 243 is intended to apply to a debt arrangement irrespective of whether the limited recourse element of the debt is achieved using an explicit contractual limitation or because of the overall effect of the arrangement.

1.10 However, the High Court in *Commissioner of Taxation v BHP Billiton Limited* [2011] HCA 17 held that the current definition only includes debt arrangements where the recourse is contractually limited or is capable of being legally limited. As such, amendments to the law are needed to ensure the limited recourse debt tax provisions operate as originally intended.

## Summary of new law

1.11 The definition of ‘limited recourse debt’ is clarified to include a debt arrangement where it is reasonable to conclude that the debtor has not been fully at risk because the creditor’s recourse is effectively limited to the financed or secured property.

## Comparison of key features of new law and current law

| *New law* | *Current law* |
|---|---|
| A debt is a limited recourse debt if it is reasonable to conclude that the rights of the creditor as against the debtor upon default in payment are in substance or effect limited wholly or predominantly to specific rights in relation to the financed property or security provided by the loan. | A debt is a limited recourse debt if the creditor’s rights of recourse are contractually limited to specific rights in relation to the financed property or security provided by the loan.<br>A debt is also a limited recourse debt if there are no specific conditions to that effect, but it is reasonable to conclude that the creditor’s rights of recourse are capable of being limited |

| *New law* | *Current law* |
|---|---|
| | to specific rights in relation to the financed property or security provided by the loan. |

## Detailed explanation of new law

1.12 To ensure that the limited recourse debt tax provisions achieve their original policy intention, the definition of 'limited recourse debt' is clarified to include debt arrangements where it is reasonable to conclude that the creditor's rights against the debtor in the event of default are in substance or effect limited wholly or predominantly to the rights in financed or secured property (which are the same as those listed in current paragraph 243-20(1)(a)). ***[Schedule #, item 1, subsection 243-20(2)]***

1.13 The amendments ensure that the limited recourse debt tax provisions are not circumvented through the use of other arrangements which have the same commercial effect as contractually limited recourse debt arrangements.

1.14 Consistent with the current law, the question of whether the creditor's rights against the debtor are limited in substance or effect is determined at the start of the arrangement (as varied prior to the termination of the debt).

**Example 1.1**

Company C, a special purpose entity (SPE) owned by an offshore company, acquires an asset for $325 million. Company C has no other assets.

Company C finances the acquisition using $65 million of equity contributed by the offshore parent company and $260 million of debt borrowed from Bank B, which only has recourse to the asset and revenue of Company C in the event of default. There is no contractual limitation on Bank B's rights to recover the debt from Company C.

The debt is a limited recourse debt for the purposes of Division 243 as Bank B's rights against Company C are effectively limited wholly or predominantly to the assets of Company C, which are predominantly financed by the debt, notwithstanding there is no contractual limitation on Bank B's rights of recourse.

In this case, Company C is at risk with respect to the $65 million equity contribution made by the offshore parent company and not fully at risk with respect to the $260 million debt borrowed from Bank B.

For tax purposes, assume the asset depreciates on a straight line basis over a 10 year period.

After four years, Company C defaults on the loan. At the time of default, the market value of the asset is $20 million and no interest payments or principal repayments have been made on the loan by Company C.

Company C has claimed $130 million (that is, $325 million/10 *4) capital allowance deductions with respect to the asset, and Company C only incurred $65 million for the asset.

As such, in Year 5, an adjustment of the capital allowance deductions claimed is made and $65 million (that is, $130 million reduced by $65 million) is added to Company C's assessable income for the year.

Overall, this ensures that Company C's capital allowance deductions are limited to the company's actual expenditure of $65 million.

### Example 1.2

Head Co is the head company of a tax consolidated group that includes a special purpose entity (SPE Co) which is a wholly owned subsidiary of Head Co. SPE Co was specifically formed to establish and operate Heart Gold Mine.

Finance Co, which operates as the 'in-house' financier for Head Co, is a 90 per cent owned subsidiary of Head Co.

Finance Co loans $2 billion to SPE Co. Under Finance Co's standard loan terms, Finance Co's rights of recourse in the event of default by SPE Co are not contractually limited. However, there are no collateral arrangements (such as a loan guarantee or letter of support from Head Co) in place in relation to this loan.

SPE Co's assets comprise project assets of the Heart Gold Mine that are financed wholly by the $2 billion loan. SPE Co has no other substantial assets.

Heart Gold Mine has not been profitable. Five years into the loan arrangement, no principal payments have been made on the loan, and interest of $500 million has been capitalised with the outstanding loan balance at $2.5 billion. Finance Co decided to write off the loan as a bad debt. At the time of the write-off, SPE Co's assets have a market value of $200 million. Head Co has no carry forward tax losses.

Up until the debt write-off, Head Co has claimed $1 billion in capital allowance deductions for the capital expenditure on project assets of the Heart Gold Mine.

**Tax consequences without the amendments**

Without the amendments Division 243 does not apply, since there is neither a contractual limitation on Finance Co's recourse to SPE Co's assets, nor a legal limitation on Finance Co's legal rights which arise otherwise than by contract.

No adjustment needs to be made to the $1 billion capital allowance deductions already claimed by Head Co and Head Co is able to claim the remaining $1 billion of capital allowance deductions if SPE Co continues to be in operation.

This is so despite the fact that SPE Co has not been fully at risk with respect to the $2 billion of debt that financed the project assets and has not repaid the debt.

If the unpaid amount of the debt is not included in assessable income under another provision, and is forgiven, the amount may be offset against amounts that could otherwise reduce Head Co's taxable income in the same or later income years (Division 245, forgiveness of commercial debts provisions). The tax consequences from the debt being forgiven depend on Head Co's tax position in the current or later income years.

As Head Co does not have current year taxable income and carry forward tax losses, there are no tax consequences from the debt being forgiven in the current year.

**Tax consequences with the amendments**

With the amendments, the debt is a limited recourse debt and the $1 billion capital allowance deductions claimed by Head Co is included in Head Co's assessable income in the year of the write-off of the debt and the remaining capital expenditure amounts of $1 billion would be reduced in future years.

1.15 In working out whether it is reasonable to conclude that the creditor's rights against the debtor in the event of default in payment of the debt or of interest are limited in substance or effect, regard must be given to:

- the debtor's assets (other than assets that are indemnities or guarantees provided in relation to the debt);

- any arrangement to which the debtor is a party; and
- whether the debtor and the creditor are dealing at arm's length in relation to the debt. ***[Schedule #, items 2 and 3, subsection 243-20(3) and (3A)]***

## Application and transitional provisions

1.16 The amendments made by this schedule apply in relation to debt arrangements terminated at or after 7.30 pm (AEST) on 8 May 2012. ***[Schedule #, item 4]***