

Clarifying the definition of limited recourse debt

Discussion paper
July 2012

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ISBN 978 0 642 74838 6

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Request for feedback and comments

The Government seeks your feedback and comments on the issue outlined in this consultation paper. To assist those wishing to make a submission, questions for consultation are located at the end of each section. However, you should feel free to address any issue raised in this paper, and should not feel obliged to address every question. The information obtained through this process will inform the Government's approach on the way forward and also assist in meeting the requirements of the Office of Best Practice Regulation.

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While submissions may be lodged electronically or by post, electronic lodgement is preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

Closing date for submissions: 10 August 2012

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1. BACKGROUND

1. In the 2012-13 Budget, the Government announced that it will amend the definition of limited recourse debt in the income tax law, to ensure that tax deductions are not available for capital expenditure on assets that have been financed by limited recourse debt, to the extent that the taxpayer is not effectively at risk for the expenditure and does not make an economic loss.
2. The proposed measure will affect the financing of projects where the borrower is a special purpose entity that has minimal or no other assets or income from other sources apart from the project assets.

1.1 LIMITED RECOURSE DEBT

3. Limited recourse is a financing arrangement that is often used in long term projects. Broadly, in such project financing, the creditor seeks to wholly or primarily rely on the cash flows and assets of the project for repayment and security. This depends on the project being completed. The decision to finance the project is based on an evaluation of the commercial viability of the project, rather than on the financial strength of the project sponsor.
4. In light of this, a key objective of the project sponsor will be to limit their exposure to the creditor's financial recourse, in the event of a default on the loan. Broadly, this is done in two ways that differ legally but are economically and substantively similar.
5. One financing approach is where the creditor lends directly to the project sponsor (or an entity controlled by the sponsor) and contractually limits its rights of financial recourse to rights in relation to the assets that are wholly or predominantly financed or secured by the loan.
6. Another approach is where the project sponsor establishes a special purpose entity as the borrower, with the effect of separating the special purpose entity's assets and liabilities from that of the sponsor. The special purpose entity becomes the project entity and its assets will comprise project assets financed wholly or predominantly by the loan.
7. The effect of a special purpose entity financing structure is that, should the contract be terminated as a result of a default in repayment by the special purpose entity, the creditor can only seek recourse on assets that are wholly or predominantly financed or secured by the loan.
8. This is the same economic and substantive outcome as that achieved by directly contractually limiting the creditor's rights to assets that are wholly or predominantly financed by a loan.

2. OUTLINE OF CURRENT LAW

9. Legislative references are to the *Income Tax Assessment Act 1997* unless otherwise stated.

10. The limited recourse debt provisions are in Division 243. The policy objective, as expressed in the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 1999, is to ensure that total deductions for allowable capital expenditure do not exceed the total amount actually expended by a taxpayer where the expenditure has been financed under hire purchase or limited recourse debt arrangements.
11. That is, the deductions are limited to the actual economic loss experienced by the debtor.
12. The legislation achieves this policy outcome by reversing capital allowance deductions that have been obtained for expenditure that is funded by debt where the debtor is not fully at risk in relation to the expenditure and the debt is not fully repaid upon termination of the debt arrangement.
13. An additional amount (worked out under the provisions) will be included in the taxpayer's assessable income where the taxpayer has:
 - not been fully at risk in relation to an amount of capital expenditure, and
 - obtained net capital allowance deductions that exceed the amount of the debt that had been repaid when the arrangement is terminated.
14. This applies to limited recourse debt arrangements because the debtor is not fully at risk.
15. Broadly, the definition of limited recourse debt in Division 243 covers:
 - an arrangement where there is a legal (contractual) limitation on the creditor's rights of recourse if the debtor defaults (subsection 243-20(1));
 - an arrangement where notwithstanding the absence of an express limitation in the loan, it is reasonable to conclude that the creditor's rights against the debtor in the event of default are 'capable of being limited' (subsection 243-20(2)).
 - an arrangement where there is no property financed by the debt or provided as security for the debt but where it is reasonable to conclude that the creditor's rights against the debtor in the event of default are capable of being limited (subsection 243-20(3)); and
 - notional loans under Division 240, which treat hire purchase agreements as if they involve the sale of property to a notional buyer using loan funds provided by the notional seller (subsection 243-20(4)).

2.1 INTERACTION WITH OTHER PROVISIONS

Commercial debt forgiveness (Division 245)

16. Broadly, a debt is a commercial debt if the borrower can deduct all or part of the interest that is payable to the creditor (or where, the interest is not deductible, could have deducted it if the interest was deductible). Generally, for a debt to be forgiven, the creditor must legally waive, release or extinguish the debt other than through paying the outstanding monies.
17. There can be some overlap between the limited recourse debt provisions and the commercial debt forgiveness rules. If this occurs, the limited recourse debt provisions will be applied first,

to disregard any operation of the commercial debt forgiveness rules (see section 243-75). The debtor's taxable income will be adjusted under the limited recourse debt provisions and the assessed amounts taken into account when reducing the gross forgiven amount under the commercial debt forgiveness rules.

Capital protected borrowings (Division 247)

18. A capital protected borrowing involves a loan facility to fund the purchase of listed shares, unit trusts, or stapled securities and where the borrower is not liable to fully repay the loan under certain circumstances.
19. The arrangement is a limited recourse borrowing as it includes a mechanism to ensure that where the value of the securities acquired is less than the value of the loan principal, the securities may be used to satisfy the loan in full.
20. The creditor's rights of recourse are limited as the borrower is granted (or effectively granted) a put option to transfer the property to the lender for the value of the loan.

Assets put to tax preferred use (Division 250)

21. These provisions seek to deny capital allowance deductions where an asset is put to a tax preferred use and the taxpayer does not have a predominant economic interest in the asset.
22. One of the tests for predominant economic interest is that the asset is not financed, more than a specified percentage limit (80% or 55%) by limited recourse debt (section 250-115).
23. Thus the limited recourse nature of financing may determine whether or not a taxpayer has a predominant economic interest in an asset.

2.2 COMMISSIONER OF TAXATION V BHP BILLITON LIMITED & OTHERS [2011] HCA 17

24. In June 2011, the High Court of Australia, handed down its judgment in *Commissioner of Taxation of the Commonwealth of Australia v BHP Billiton Limited & others* [2011] HCA 17 (*BHP Billiton*).
25. The High Court considered the meaning of subsection 243-20(2), and the phrase 'that the rights of the creditor ... are capable of being limited'.
26. The High Court considered that the creditor's rights to recourse against the borrower in the event of default are only limited where, at the inception of the loan, the borrower (or someone else) has the capacity to bring about the limitation whether by arrangement, circumstance, conduct or some other way covered by subsection 243-20(1).
27. The Court further considered that the power to limit the creditor's rights of recourse would not be satisfied by the existence, at the inception of the loan, of a possibility of a person acquiring a capacity (that is a power) to limit, or a power to cause the relevant limitation of, a creditor's rights of recourse at some point in the future.
28. Currently, if such a limitation occurs and the arrangement is terminated upon the borrower's default, where the debt has not been fully repaid, capital allowance deductions that exceed the repaid amounts will not be included in assessable income.

29. This interpretation may result in different treatment for arrangements that have the same economic and substantive outcome, based on the timing and form of the 'capacity to bring about the limitation'.
30. This is contrary to the policy objectives of Division 243, as expressed in the Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 1999, which is to ensure that total deductions for allowable capital expenditure do not exceed the total amount actually expended by a taxpayer where the expenditure has been financed under hire purchase or limited recourse debt arrangements.

3. ENSURING THAT DIVISION 243 OPERATES AS INTENDED

3.1 AMENDING THE DEFINITION OF LIMITED RECOURSE DEBT

31. The reversal of capital allowance deductions is not intended to be restricted to situations where the arrangement specifies conditions that limit the recourse of the creditor.
32. The Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 5) 1999 states that '... a debt is also limited recourse if, notwithstanding that there may be no specific conditions to that effect, it is reasonable to conclude that the creditor's rights against the debtor are able to be limited, directly or indirectly, to those property rights specified in new subsection 243-20(1) in relation to the financed property.'
33. The definition of limited recourse debt will be amended in order to achieve the policy objectives of Division 243 and provide the same tax treatment for arrangements that are economically and substantively the same, notwithstanding their different legal form.
34. This will enable appropriate adjustments to be made to the borrower's taxable income, where the arrangement is terminated and the debt has not been paid in full by the debtor and the creditor's rights of recourse are limited wholly or predominantly (whether or not by contract) to certain rights in respect of the financed property or other property.

Proposed changes

35. Section 243-20 will be amended to define a limited recourse debt as including arrangements where at the beginning, the creditor's rights against the debtor, in the event of default in payment of the debt, are limited wholly or predominantly (whether or not by contract) to certain rights in respect of the financed property or other property.

Example of arrangement

36. Company C, a special purpose vehicle owned by an off-shore company, acquires an asset for \$325 million. Company C has no other assets.
37. Company C finances the acquisition using \$65 million equity contributed by the off-shore parent company and \$260 million 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.

38. Under the proposed changes, the debt would be limited recourse debt as Bank B's rights against Company C are effectively limited wholly or predominantly to the assets of Company C which are financed by the debt, notwithstanding there is no contractual limit.

Date of application

39. This measure will have effect from 7.30pm (AEST) on 8 May 2012.
40. The proposed definition will apply to terminations (arising from the borrower's default) that occur after this time. Although the beginning of the arrangement is not relevant to the question of whether there is a termination, it is appropriate to have regard to the beginning of the arrangement when determining if the arrangement is a limited recourse debt. This is because the terms, rights and other matters that affect its qualification as a limited recourse debt are determined at that point, regardless of whether or not a termination occurs.