

TD 2009/D12 - Income tax: can Part IVA of the Income Tax Assessment Act 1936 apply to an asymmetric swap scheme?

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This document has been finalised by This Draft Determination has been finalised by TD 2010/12.

 There is a Compendium for this document: **TD 2010/12EC** .



Draft Taxation Determination

Income tax: can Part IVA of the *Income Tax Assessment Act 1936* apply to an asymmetric swap scheme?

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Ruling

1. Yes, Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) can apply to an asymmetric swap scheme.

Date of effect

2. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 75 to 77 of Taxation Ruling TR 2006/10).

Appendix 1 – Explanation

① *This Appendix is provided as information to help you understand how the Commissioner’s preliminary view has been reached. It does not form part of the proposed binding public ruling.*

Explanation

3. An asymmetric swap scheme commonly consists of two swap transactions entered into between an Australian resident company and an unrelated non-resident counterparty (the non-resident counterparty).

4. The non-resident counterparty is commonly an international financial institution that develops, trades in, and markets exposures to proprietary benchmark indexes in equities, commodities, and currencies.

5. The Australian resident company (for example, a financial institution) uses a business unit that is subject to a lower effective tax rate, due to the concessional treatment afforded to income and deductions, such as an offshore banking unit (OBU),¹ to enter into a short swap with the non-resident counterparty over an equity, commodity or currency benchmark index.

6. The Australian resident company uses its business unit that is subject to the normal company tax rate, such as the domestic banking unit (DBU), to enter into a long swap with the non-resident counterparty over the same equity, commodity or currency benchmark index.

7. In some instances, the commonly used structure is varied so that the Australian resident company may interpose a subsidiary company, (that is outside its consolidated tax group) who enters into the long swap with the non-resident counterparty; that interposed subsidiary, in turn, then enters into a back to back long swap with the Australian resident company.

8. The non-resident counterparty makes a payment over the term of the short swap to the OBU. The non-resident counterparty also makes a payment over the term of the long swap to the DBU. The parties describe this payment as a fee to induce the OBU & DBU to enter the short swap and the long swap respectively. The fee is calculated as a percentage of the notional principal amount (NPA) of each swap.

9. The long swap and the short swap are not symmetric because the NPA of each swap is calculated by reference to the different tax rates applicable to the Australian resident company (DBU) and the business unit (OBU), that is, the mathematical relationship is usually fixed as follows:

$$\text{NPA of the short swap} = \text{NPA of the long swap} \times \frac{1 - \text{high tax rate}}{1 - \text{low tax rate}}$$

¹ An OBU is used as the example in this draft Determination, however, any entity with a lower effective tax rate could be utilised, for example, a non-resident subsidiary, a loss company, a life assurance company and superannuation fund.

10. The Australian resident company (that is, the DBU and OBU) will have a net long exposure, whereas the non-resident counterparty will have an identical net short exposure. The Australian resident group has a pre-tax Profit & Loss exposure, but due to the structure of the scheme does not have any exposure on an after tax basis.

11. Prior to entering into the asymmetric swap scheme, the parties agree upon the features of the swaps, including:

- The selection of a particular equity, commodity or currency benchmark index and/or its sub-indices, the performance of which forms the subject matter of the swap.
- Any capacity to change the benchmark index or its components over the life of the swaps.
- The NPA of the long swap and the NPA of the short swap.
- The size of the leverage factor (LF). The LF compounds the difference between the movement in the index and the drift up to the level of the cap, collar or floor, for example, multiplied by a factor of 5.
- The amount of the 'drift adjustment' percentage which is commonly based upon the historical performance of the benchmark index, for example, over a preceding period of time the index rose on average by 4%. The parties agree to impose the drift adjustment percentage at the start of the swap term.
- The duration of the swaps.
- Any caps, floors or collars setting the range within which the swaps may trade, and limiting the upside and downside exposure to gains and losses arising from movements in the index.
- Early termination rights or suspension rights.

12. The selection and calculation of these features, particularly the drift adjustment, purports to have the effect that at the time the swaps are entered into, there is a neutral expectation of a profit or loss arising in either the long or short swap.

The Application of Part IVA

13. Part IVA of the ITAA 1936 can only apply to the scheme if it has its intended effect under Division 9A of Part III of the ITAA 1936 (Division 9A). Division 9A provides for the taxation treatment of OBUs. However, this draft Determination does not analyse the operation of Division 9A. For present purposes it is assumed (but not ruled) that the scheme is effective.

14. Part IVA of the ITAA 1936 will apply to the asymmetric swap scheme where a taxpayer who participates in the scheme obtains a tax benefit in connection with the scheme and having regard to the eight factors in section 177D of the ITAA 1936 it would be concluded that one of the persons who entered into or carried out the scheme did so for the dominant purpose of enabling the participating taxpayer to obtain a tax benefit in connection with the scheme.

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15. The drift adjustment is commercially unsound. Having regard to the structuring of the transaction through business units with different tax rates, the drift adjustment introduces a bias into the probable performance of the swaps for the purpose of obtaining a tax benefit in the form of an allowable deduction or an amount not being included in assessable income. A reasonable person, having regard to the matters in paragraph 177D(b) of the ITAA 1936 would conclude that the dominant purpose of the participants in entering into and carrying out the scheme is to obtain a tax benefit and the fees attributable to the tax benefit. Through the calculation of the fees the benefit of the deduction or omitted income is intended to be shared between the participants.

16. Having regard to the structuring of the transaction through business units with different tax rates, other features of the asymmetric swap scheme such as the leverage factor, components of the benchmark index, caps, floors or collars or suspension or termination rights, might also be selected or calculated in an uncommercial manner such that it would be concluded that the dominant purpose of the participants in entering into or carrying out the scheme was to obtain a tax benefit.

Appendix 2 – Your comments

17. You are invited to comment on this draft Determination. Please forward your comments to the contact officer by the due date.

18. A compendium of comments is also prepared for the consideration of the relevant Rulings Panel or relevant tax officers. An edited version (names and identifying information removed) of the compendium of comments will also be prepared to:

- provide responses to persons providing comments; and
- publish on the Tax Office website at www.ato.gov.au

Please advise if you do not want your comments included in the edited version of the compendium.

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References

Previous draft:

Not previously issued as a draft

- Part IVA
- swaps
- tax benefits under tax avoidance schemes

Related Rulings/Determinations:

TR 2006/10

Legislative references:

Subject references:

- financial derivatives
- offshore banking units

- ITAA 1936 Pt III Div 9A
- ITAA 1936 Pt IVA
- ITAA 1936 177D
- ITAA 1936 177D(b)

ATO references

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