IT 2495 - Income tax : debt defeasance arrangements : liability assumption

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TAXATION RULING NO. IT 2495

INCOME TAX : DEBT DEFEASANCE ARRANGEMENTS : LIABILITY ASSUMPTION

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1010828	DEBT DEFEASANCE	DIV.16E, 25, 25A,

PREAMBLE This Taxation Ruling deals with the income tax consequences for a borrower who engages in a debt defeasance transaction. For the purposes of this Taxation Ruling the term "debt defeasance" is used to describe arrangements where a borrower liable to repay a loan at some future date pays a third party (sometimes referred to as "the assumer") an amount approximating the present value of the loan in consideration for the third party agreeing to pay the amount owed by the borrower when it becomes due. For example, a company might borrow, say, $100m for five years or issue debentures worth $100m which mature in five years time. The borrower then pays, say, $60m to a third party to take over the liability to repay the $100m in five years time. The borrower is left with $40m which does not have to be repaid.

2. The liability for interest payments on the $100m is left with the borrower. Alternatively, a third party might take over the liability for interest payments.

3. Moreover, debt defeasance can be undertaken in relation to existing loans or securities (which may be several years old) or new loans or securities.

4. Broadly, this type of arrangement for defeasing a debt operates in one of two ways:

(a) The borrower, lender and the third party are all parties to the agreements. The borrower pays to the third party an amount approximating the present value of the borrower's debt obligation. The third party agrees to pay to the lender at the end of the loan period an amount equivalent to the borrower's debt obligation. The lender agrees to the immediate release of the borrower from the contractual obligation to repay the loan principal in consideration for the third party agreeing to pay the lender the amount of the debt when due.

The promise made by the third party is a promise to both the borrower and the lender, each of whom provide consideration for that promise - the borrower by paying the $60m referred to in the example, the lender by agreeing to the immediate release of the borrower from the obligation to repay the loan principal. It would appear that both the borrower and the lender would have a right of action to enforce the promise if the third party defaults. The lender may also have a right of action against the borrower if the borrower defaults on the payments in respect of the interest component.

A variation of this tripartite approach is where, instead of the third party immediately promising to pay when due an amount equal to the principal owed by the borrower, the third party's promise to the borrower is that it will enter into an agreement with the lender under which the third party will agree to pay the lender, when due, an amount equivalent to the loan principal. In consideration for this promise the lender agrees to immediately release the borrower when the third party duly enters into the promised agreements. This results in the performance of the agreement between the borrower and the third party. Thereafter, only the lender appears to have a cause of action against the third party for repayment.

One of the consequences of tripartite agreements is that a financial instrument in the nature of a discounted security is created in favour of the borrower against the third party, the discount being a benefit to the borrower. The face value of the security (which includes the amount of the discount) is payable to the lender pursuant to the borrower's direction given in the agreements.

(b) This method involves a similar agreement between the borrower and the third party. However, the original lender is not a party to the arrangement and the borrower's primary contractual obligation to repay the lender is unaltered. The agreement between the borrower and the third party represents a chose in action in the nature of a discounted security in favour of the borrower and which the borrower can enforce at maturity. Its effect is that, in an economic sense, the borrower is relieved of the obligation to repay the loan since the borrower can call on the third party to find the necessary funds.

There may be minor variations on these two basic approaches e.g., the lender may be a party to the type (b) arrangement.

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5. The difference between the amount paid by the borrower to obtain the undertaking by the third party to repay the loan and the benefit obtained by the borrower by having the loan repaid by the third party, i.e., $40m in the example in paragraph 1, is an assessable gain to the borrower under subsection 25(1) and/or section 25A.

6. The gain is in the nature of discount income realised by the borrower when the borrower's liability to repay the loan is discharged. In entering the defeasance arrangement with the third party the borrower intends to make a profit. The profit is quantified and agreed at the outset. The derivation of the profit is essential to the borrower's purpose of defeasing the principal amount of the loan. Accordingly, the profit is income according to ordinary concepts. It has been the longstanding practice of the Australian Taxation Office to treat gains in the nature of discount income as assessable income.

7. The relevant accounting basis employed in calculating profits and losses for the purposes of the Income Tax Assessment Act (other than Part 111A of that Act) is historical cost and not economic equivalence (FC of T v Myer Emporium Ltd (1987) 18 ATR 693 at 702; 87 ATC 4363 at 4370-1).

8. It is considered that the profit implicit in the defeasance arrangement is assessable income regardless of whether the defeasance occurs in relation to existing debt (perhaps some years old) or whether in relation to a loan obtained just prior to the defeasance (this second type sometimes being referred to as instantaneous defeasance).

9. Where the method described in paragraph 4(a) is used, the gain is derived when the lender releases the borrower and the borrower is assessable in full in that year of income.

10. However, where the method outlined in paragraph 4(b) is used, Division 16E operates to bring the gain to account as assessable income of the borrower on an accruals basis over the period between the giving of the undertaking by the third party and the due date(s) for making the payment(s) pursuant to that undertaking. (In the absence of Division 16E the gain would have been assessable when payment was made by the third party.)

11. It is questionable whether, after the liability to repay the principal has been defeased, claims for deductions for interest payments or payments made for the assumption of interest obligations under the original borrowing are allowable, either wholly or in part. It is arguable that insofar as there is no extant principal obligation, there can be no interest obligation and therefore no deduction is allowable.

12. It is considered that deductions for interest or interest assumption payments should be wholly disallowed until the outcome of any appellate processes in the matter is finally resolved.

13. At the same time, in the situations to which this Ruling is directed paragraphs 21-37 of Taxation Ruling No. IT 2156 should be applied in relation to recovery of outstanding tax.

COMMISSIONER OF TAXATION
15 September 1988