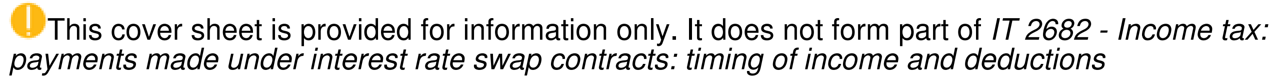
IT 2682 - Income tax: payments made under interest rate swap contracts: timing of income and deductions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Taxation Ruling
Income tax: payments made under interest rate swap contracts: timing of income and deductions

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What this Ruling is about

1. This Ruling clarifies when payments received or made under an interest rate swap contract are to be brought to account as income or deductions for the purposes of the *Income Tax Assessment Act 1936*. The Ruling proceeds on the general principle set out at paragraph 8 of Taxation Ruling IT 2050 that swap payments are assessable to the recipient, and deductible to the payer, under subsections 25(1) and 51(1) respectively.

Ruling

2. Given the periodical nature of interest rate swaps entered into under either the ISDA Agreement or the AIRS Terms, a presently existing liability to make each fixed or floating rate payment arises at the beginning of each related swap calculation period notwithstanding that such payments are payable at a later time. However, in the context of interest rate swaps where a series of payments of a similar nature can flow between counterparties over a (sometimes considerable) period of time under a single agreement, the generally accepted accounting practice of apportioning payments on a daily accruals basis fairly reflects the extent to which a counterparty incurs swap outgoings in a particular year of income. Accordingly, deductions allowable to a taxpayer under subsection 51(1) for floating and fixed rate payment liabilities should be apportioned on a daily accruals basis over each related calculation period.

3. Having regard to the nature of interest rate swaps, the apportionment of swap receipts over the calculation periods to which they relate using the daily accruals method provides a correct reflex of

the amount of swap income derived by a taxpayer in each year of income consistent with accounting practice and the matching principle. Accordingly, in determining assessable income, fixed and floating rate income derived under interest rate swaps entered into under the ISDA Ageement or AIRS Terms should be allocated on a daily basis over the calculation period to which each payment relates.

4. Where payments are set off against each other as described at paragraph 34, section 19 operates to treat the gross amounts of each counterparty as having been derived by each counterparty, the relevant portion being allocated to the related income year on a daily accruals basis.

5. Swap fees are deductible when they are due. As to when a fee accrues due depends on the terms of the contract. A fee payable at the time of entering the contract would generally be deductible at that time. However, if the fees were payable at some other point of time, say at the end of the contract it would be necessary to determine in terms of the agreement when the amounts are due. Fees paid for the arrangement of a swap contract may be subject to the advance expenditure rules in section 82KZM.

6. Subject to the swap being a 'bona fide swap' as discussed at paragraphs 85 to 87, where an accelerated payment is made under either the ISDA Agreement or the AIRS Terms the entire payment is incurred and deductible at the time of payment. Similarly, it is considered that a swap counterparty who receives such payment derives that income at the time of receipt. In addition, swap payments made under a bona fide interest rate swap agreement are not considered to be payments 'incurred in return for the doing of a thing...' within the meaning of section 82KZM. Therefore, section 82KZM does not apply to swap payments in advance.

7. This Ruling applies to all interest rate swap contracts entered into by a taxpayer for hedging or trading purposes, including accelerated and deferred interest rate swaps. This Ruling does not apply to interest rate swaps having the characteristics described at paragraphs 85 to 87 of this Ruling. In determining whether a particular swap is a bona fide interest rate swap different considerations come into play if an agreement in the form of an interest rate swap truly reflected the provision of finance by one party to another or, conversely, could be seen in substance as an investment. Further, if there are substantial differences between the fixed and floating rates of interest at the time the parties enter into an interest rate swap then those circumstances require examination to decide whether the swap payments and receipts are truly of a revenue nature.

Date of effect

8. Subject to the qualifications set out at paragraphs 16, 89 and 90, this Ruling applies to all interest rate swap agreements entered into on and from 21 May 1992.

Explanations

9. An interest rate swap is an agreement between two parties to exchange two different cash flows over time in respect of a notional principal amount. The payments are tied, at least in part, to subsequent and uncertain market price developments.

10. The practical effect of entering into an interest rate swap transaction is to substitute liability for an interest rate regime (fixed or floating rate) with a regime of swap payments. However, a swap does not affect the underlying contractual liabilities of the swap counterparties. A counterparty remains legally obligated to its original lender to make loan repayments and to pay interest under the relevant loan agreement. Further, the rights and obligations of parties to swaps do not depend upon the existence of an underlying loan. It should therefore be noted that, while swap payments are calculated with reference to interest obligations, the swap payments themselves are not interest payments nor are they in the nature of interest. (See also IT 2050 at paragraphs 5 to 7).

11. There are at least three different methods of accounting for swap transactions being used by parties to interest rate swaps. These are the 'due and receivable/due and payable', the 'mark to market' (fair market value or replacement cost), and the 'daily accruals' bases.

12. Generally, in an interest rate swap at least one of the parties will have an underlying loan obligation with either a fixed or floating rate of interest. For a variety of reasons, a counterparty may wish to change its interest exposure from a floating rate to a fixed rate or vice versa. In such a case, one party would assume the interest rate exposure of the other. Hence, one of the parties to a swap contract will receive fixed rate payments and make floating rate payments and the other party will receive floating rate payments and make fixed rate payments. The payments are calculated on a notional principal amount.

13. However, it is more common for the original party to approach a financial institution which acts as an intermediary or

which operates a swap book. In such a case the financial institution does not have an underlying loan but enters into the swap agreements as part of its business.

14. Another situation is where both parties to a particular swap may be financial institutions who are either intermediaries or swap book operators, neither of whom is hedging an underlying loan obligation.

15. The economic rationale for interest rate swaps arises from arbitrage opportunities that occur as a result of different perceptions of risk, and credit standing, held by different markets or as a result of restrictions on access to particular markets. Taxpayers, including government bodies and corporates engaged in a business other than banking or finance, usually enter the swap market to hedge interest rate exposure. However, taxpayers sometimes enter the swaps market for trading purposes or speculative purposes.

16. This Ruling applies to all of the following interest rate swap contracts entered into by a taxpayer (including accelerated and deferred interest rate swaps but excepting swaps having the characteristics of a non bona fide swap, as discussed at paragraphs 85 to 87):

a) If the taxpayer uses the swap as a hedge to limit an exposure to interest rate fluctuations on an underlying loan; or

b) If the taxpayer acts as an intermediary; that is, if the taxpayer, usually a financial institution, has no underlying loan on which it is attempting to hedge its interest rate risk exposure but rather becomes a counterparty to two equal but opposite swaps with parties who are seeking to change their interest rate exposure. (On one swap the intermediary would receive fixed rate payments and pay floating rate payments while on the other swap it would receive floating rate payments and pay fixed rate payments).

   The intermediary would usually charge a fee up front and possibly an administration fee at the end of the swap, as well as seeking to make profits through arbitrage. The intermediary receives payments from and makes payments to the two counterparties; or

c) If the taxpayer operates a swap book. Swap books are generally operated by large financial institutions. Like an intermediary, an institution operating a swap book does not have underlying loans in respect of the swaps it enters.

The operation of the swap book is part of the financial institution's business and it makes profits through arbitrage and the charging of fees. However, unlike an intermediary, a financial institution operating a swap book may not for every swap it enters seek to enter another equal and opposite swap, but would attempt to achieve a desired risk exposure on the swap book as a whole.

17. Interest rate swaps generally take one of the following forms:

a) counterparty A will make periodic payments to, and receive periodic payments from, counterparty B;

b) counterparty A will make an upfront lump sum payment to, and will receive periodic payments from, counterparty B;

c) counterparty A will make a backend lump sum payment to, and receive periodic payments from, counterparty B;

d) counterparty A will make periodic payments to, and receive an upfront lump sum payment from, counterparty B;

e) counterparty A will make periodic payments to, and receive a backend lump sum payment from, counterparty B.

18. In the past, the most common documentation used by parties to an interest rate swap transaction was the General Terms and Conditions of Australian Dollar Fixed/Floating Interest Rate Swaps (AIRS Terms). However, industry submissions indicate that most new interest rate swap contracts are written under an Australian version of the Interest Rate and Currency Exchange Agreement developed by The International Swap Dealers Association (ISDA Agreement). It is common for parties to modify the terms of the AIRS and ISDA documentation for individual swaps but the basic operation of the swap remains generally unaltered. This Ruling addresses the situation where the AIRS Terms and ISDA Agreement are not altered to any significant extent.

Rights and Obligations under the ISDA Agreement and AIRS Terms

19. Under both the ISDA Agreement and AIRS Terms each party agrees to pay to the other the equivalent of its interest obligation in

respect of a notional principal amount. However, there are differences in how this is effected under the two sets of documentation.

20. The ISDA Agreement accommodates interest rate swaps in any currency as well as currency swaps and consists of three parts. The first part is a standard master agreement (the ISDA master agreement) which sets forth basic terms of the swap contract. The second part is the Schedule to the master agreement (the Schedule), in which some of the terms contained in the master agreement may be completed, supplemented or varied.

21. The third part of the ISDA Agreement is the Confirmation. The Australian Financial Markets Association and the International Swap Dealers Association have published the 1991 'Australian Guide to Completion of AFMA/ISDA Standard Documentation' (the Guide) to assist in the process of standardising swap agreements. Part 6 of the Guide contains a sample Confirmation to be used in an interest rate swap. The ISDA Agreement provides for individual transactions to be completed through an exchange of such standardised Confirmations between the parties. Confirmations set forth particular financial provisions of each swap, including the following:

. The notional principal amount

. The date on which the parties entered into the swap transaction

. The first and last days of the swap term

. Details relevant to the fixed rate payer's obligations:

- payment dates;
- fixed rate; and
- fixed amount payable

. Details relevant to the floating rate payer's obligations:

- payment dates; and
- reset dates (Floating rates are determined on reset dates.)

22. The standard Confirmation also identifies one of the parties or a third party as a 'calculation agent' responsible for calculating and notifying both the floating and fixed periodical payments under the swap.

23. Each of the ISDA master agreement, Schedule and Confirmation is required to be construed as anintegral part of a single agreement between the parties to a swap.

24. Also important to understanding the terms of the ISDA Agreement is the 1991 ISDA Definitions (the 1991 Definitions) produced by the International Swap Dealers Association for optional

use as a companion to the ISDA Agreement. The 1991 Definitions replaced an earlier 1987 version for new swap transactions where the relevant Confirmation refers to those definitions. The 1991 Definitions determine the meaning of various financial provisions which can be selected to apply to a swap transaction.

25. The contractual relationship between the parties under the AIRS Terms arises from 'The General Terms and Conditions' agreement (the AIRS master agreement), and a 'Confirmation' of particulars which is exchanged between the swap parties. Provision for variations to the swap agreement is made in the Confirmation.

26. The standard Confirmation is set out at Schedule 1 to the AIRS master agreement and sets forth similar financial provisions to those included in an ISDA Confirmation except that there is no provision for detailing the fixed amount payable or floating rate reset dates. However, given the nature of the calculation of the fixed rate payment as defined in the AIRS master agreement, it is apparent that the identification of the notional principal, fixed reference rate and the fixed rate payment dates in the Confirmation enable the determination of the fixed rate payment amount from the date the Confirmation is exchanged between the parties. The parties to a swap are therefore generally able to determine the fixed payment amount at the commencement of the swap through the performance of a calculation similar to that undertaken when calculating simple interest.

27. The reference period in respect of which a swap payment is calculated is similar to an interest period in a borrowing and is known under both the ISDA Agreement and AIRS Terms as the 'calculation period'. The 1991 Definitions relate each swap payment under an ISDA Agreement to a particular calculation period and to each counterparty to the swap. Therefore separate and distinct calculation periods evolve for both fixed and floating rate payers. Calculation periods are generally delimited by the relevant 'calculation dates' and 'payment dates' or 'period end dates' of each party to the swap.

28. There is only one set of calculation periods under the AIRS Terms and they are determined by reference to floating rate payments. That is, calculation periods under the AIRS Terms commence with a calculation date and run until the next date preceding the next floating rate payment. Thus each calculation period runs between the floating rate payment dates specified in the Confirmation (except for periods including either the commencement or maturity dates of the swap). Despite the absence of any specific provision for fixed rate calculation periods it is nevertheless implicit under the AIRS Terms that separate calculation periods also exist for fixed rate payments. In practical terms, the fixed rate payment periods for a swap are delimited through the specification in the Confirmation of the commencement and maturity dates of the swap and the fixed rate payment dates. Such

construction of the AIRS Terms is consistent with industry practice and places the situation with respect to calculation periods under AIRS on a similar footing to that which exists under the ISDA Agreement.

29. The essential payment obligations of each of the counterparties under an ISDA Agreement are set out in subclause 2(a) of the ISDA master agreement, as follows:

> '(i) Each party will make each payment specified in each Confirmation as being payable by it.
> (ii) Payments under this Agreement will be made not later than the due date for value on that date in the place of the account specified in the relevant Confirmation or otherwise pursuant to this Agreement, in freely transferable funds and in the manner customary for payments in the required currency.
> (iii) Each obligation of each party to pay any amount due under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing and (2) each other applicable condition precedent specified in this Agreement.'

30. Clause 3 of the AIRS master agreement also seeks to establish liability between the swap parties to make payments on their respective due dates. Clause 3 is essentially in two parts and provides as follows:

> 'On the Calculation Date in respect of each Calculation Period, the Fixed Rate Payer shall determine the Floating Rate Payment and the Fixed Rate Payment payable on the relevant Floating Rate Payment Date or Fixed Rate Payment Date, as the case may be, and the date of such Floating Rate Payment Date or Fixed Rate Payment Date (if appropriate) and as soon as reasonably practicable notify the Floating Rate Payer thereof.
> The Fixed Rate Payer agrees to pay to the Floating Rate Payer on each Fixed Rate Payment Date the relevant Fixed Rate Payment; and the Floating Rate Payer agrees to pay to the Fixed Rate Payer on each Floating Rate Payment Date the relevant Floating Rate Payment.' (Paragraph break inserted)

31. It is proper when interpreting agreements to have regard to long established industry policy and practice (cf. *Commercial Union Assurance Company of Australia Ltd v. FC of T* 77 ATC 4186 at 4193-4; (1977) 7 ATR 435 at 443-4). The second sentence of clause 3 is generally accepted as being a stand alone general agreement

between the swap parties whereby they agree to honour their payment obligations under the swap. This leads to a general obligation to pay the amounts due similar in effect, and consistent with, the general agreement made pursuant to paragraphs 2(a)(i) and (ii) of the ISDA Agreement. In addition, each counterparty under both ISDA and AIRS warrants that it is legally and validly bound by the respective terms of those agreements.

32. Accordingly, upon completion of the Confirmation under both ISDA and AIRS, counterparties create a legal obligation to make fixed or floating payments specified as being payable on certain payment dates.

33. Clause 3 of the AIRS master agreement needs to be contrasted with subclause 4(b) which determines that each payment to be made by either party under the swap agreement shall be made when such payments are due. We consider that clause 3 determines when the pecuniary liability accrues due while subclause 4(b) ensures that actual payment of the liability must, subject to set-off, be made when due. That is, given the context in which it appears, the term 'due' in subclause 4(b) of the AIRS Terms is used in the sense of payable. (cf. *Mack v. Commr. of Stamp Duties (N.S.W.)* (1920) 28 CLR 373 at 382; *Clyne & Anor v. D.F.C. of T. and Anor* 81 ATC 4429 at 4436; (1981) 12 ATR 173 at 181).

34. Both the ISDA Agreement and AIRS Terms reduce delivery risk (that is, the risk that one party will make one payment without receiving the other party's corresponding payment), by contractually providing for payments set off or netting. That is, if fixed and floating rate payments under a swap or a series of swaps are due and payable on the same day, payments may be set off against each other with only the difference being paid. The party liable for the greater amount pays the difference between the two amounts to its counterparty. However, payments netting does not affect the true level of exposures between counterparties. Further, in most interest rate swaps, payments do not coincide and calculation periods are of different duration. For example, floating rate payments will usually be made every 90 days and the fixed rate payments will usually be made annually or semi-annually.

35. It is an important feature of swaps that, except to the extent that a party is in default on a prior payment or otherwise covered by the 'conditions precedent' provision of the ISDA Agreement, swap agreements do not provide for payments to be conditional on each other.

36. Moreover, given that swap contracts are divisible into periodic obligations, if a party defaulted on a single payment under an agreement which did not provide for termination, a non-defaulting

party may well be limited in its ability to sue on the entire contract: Schuyler K. Henderson and John A.M. Price, *Currency and Interest Rate Swaps,* 2nd ed. 1988, Butterworths, p. 141.

37. The requirement to make payments on their due date under both ISDA and AIRS is not subject to any condition subsequent. Therefore, a non-defaulting party cannot recover its previous swap payment on the ground that it was made contingent upon its counterparty performing its subsequent payment obligations.

38. Both the ISDA and AIRS master agreements address short term delivery risk by identifying 'events of default' (including the failure by a party to honour its payment obligations, misrepresentation and bankruptcy). Paragraph 2(a)(iii) of the ISDA Agreement (set out at paragraph 29 of this Ruling), explicitly provides for 'events of default' and 'potential events of default' to constitute conditions precedent to payment. Thus, a non-defaulting party is permitted to withhold payment pending an early termination, without itself being in breach of the agreement or subject to paying default interest. The AIRS Terms do not contain any clause which parallels paragraph 2(a)(iii) of the ISDA Agreement, although substantially the same result is achieved through its own 'event of default' provisions.

39. The non-defaulting party may exercise its rights under the ISDA Agreement by issuing the appropriate notice to the defaulting counterparty designating an 'early termination date' for all swaps with the defaulting party and seek compensatory damages that are expressed to be 'a reasonable pre-estimate of loss' and 'payable for the loss of bargain and the loss of protection against future risks'.

40. The ISDA master agreement provides for each party to the swap to calculate all amounts due (including default interest) in settlement of the default and to notify the other party of the calculations. Where one party performs an event of default, that party is required to pay to the non-defaulting party either:

(A) an independently determined market value for the remainder of the swap rights and obligations <u>plus</u> unpaid amounts owed to the non-defaulting party that were due and payable for all periods ended on or before the early termination date <u>less</u> unpaid amounts, together with default interest, owed to the defaulting party by the non-defaulting party (the preceding amounts are defined collectively as the 'settlement amount') <u>plus</u> default interest calculated on a daily compounding basis over the actual number of days elapsed since the early termination date at a per annum rate of 1% over the non-defaulting party's cost of funding the settlement amount; or,

(B) if the market value of the swap cannot be determined, an amount required as at early termination date to compensate the non-

defaulting party for any losses and costs (including loss of bargain and costs of funding but excluding legal fees and other out of pocket expenses) incurred as a result of the early termination of the swap plus unpaid amounts that were due and payable for all periods ended on or before the early termination date less unpaid amounts together with default interest owed to the defaulting party by the non-defaulting party (the preceding amounts are known as the 'settlement amount') plus default interest calculated on a daily compounding basis over the actual number of days elapsed since the early termination date at a per annum rate of 1% over the non-defaulting party's cost of funding the settlement amount.

41. Upon an event of default under the AIRS Terms, the non-defaulting party may terminate its future payment obligations by lodging a written notice with the defaulting party designating a 'termination date'. In the event of termination the defaulting party pays either:

(A) an independently determined 'replacement value' for the remainder of the swap rights and obligations (that is, a market value for the swap) plus all other amounts due and unpaid as at termination date; or,

(B) if the 'replacement value' of the swap cannot be determined, an amount of compensation that ensures that the aggrieved party is fully indemnified against all costs and losses reasonably incurred as a result of the early termination of the swap, including reasonable legal or out of pocket expenses and any losses sustained or costs incurred in making alternative arrangements to secure the financial equivalent of the fixed or floating payments and receipts due in terms of the original swap agreement plus default interest calculated from termination date at a rate equivalent to the non-defaulting party's (or its banker's) overdraft rate for sums in excess of $100,000.

42. Termination under the compensation provisions referred to in paragraphs 38 to 41 may be a last resort. For example, Henderson and Price in *Currency and Interest Rate Swaps* (supra, at p. 142) state that in some instances (in relation to swaps entered into under the ISDA Agreement), 'a party may wish not to terminate but to take legal action for a specific breach. For instance, in the unlikely event that a wilful payment default (where an agreement has become unfavourable to the payer) occurs and there is no reliable market for a replacement swap, the non-defaulting party could elect not to terminate and instead to sue for each specific payment due, also claiming under provisions in the agreement providing for accrual of default interest and reimbursement of legal expenses.'

Timing of Deductions for Swap Payments in Arrears

43. To determine when an outgoing is deductible it is necessary to determine when that outgoing is incurred within the meaning of subsection 51(1).

44. The courts have on many occasions considered what is meant by the term 'incurred'. It has been variously held to include a loss or expenditure that has been 'encountered, run into, or fallen upon'; to cover outgoings to which a taxpayer is 'definitively committed' or has 'completely subjected' itself; and to be a liability which has 'come home' in the year of income in the sense of a pecuniary obligation which has become due. (cf. *New Zealand Flax Investments Limited v. FC of T* (1938) 61 CLR 179 at 207; *FC of T v. James Flood Pty Limited* (1953) 88 CLR 492 at 506; *Nilsen Development Laboratories Pty Limited & Ors v. FC of T* 81 ATC 4031 at 4034-5; (1981) 11 ATR 505 at 509).

45. The difficulty that the courts have encountered in interpreting the term 'incurred' is evident from the comments of Dixon J (as he then was) in *New Zealand Flax Investments* (supra, at CLR 207) where he stated that 'it is unsafe to attempt exhaustive definitions of a conception intended to have such a various or multifarious application'. See also the dicta of Barwick CJ in *Nilsen Development Laboratories Pty Limited & Ors v. F.C. of T.* (supra, at ATC 4034-5; ATR at 509) to the effect that an 'exhaustive definition of what may be denoted by the word "incurred" in sec. 51(1) may not be possible.'

46. Generally speaking, however, the courts have held that a loss or outgoing is incurred in the year in which there is a presently existing liability to discharge an obligation which is due. That is, the loss or outgoing must be a presently existing pecuniary obligation that has become due irrespective of whether it is payable now or in the future; a *debitum in praesenti solvendum in futuro,* viz. an amount owed at the present time, payable (or to be performed) in the future. [cf. *Webb v. Stenton* (1883) 11 Q.B.D. 518 at 527; *FC of T v. James Flood Pty Limited,* supra, at 506; *Jolly v. FC of T* (1933) 50 C.L.R. 131 at 137; *Emu Bay Railway Co. Limited. v. FC of T* (1944) 71 CLR 596 at 606 & 621; *Nilsen Development Laboratories Pty Limited & Ors v. FC of T,* supra, at 4034-7, ATR at 508-12; *FC of T v. Lau* 84 ATC 4929 at 4940; (1984) 16 ATR 55 at 68; *FC of T v. Australian Guarantee Corporation Limited* 84 ATC 4642 at 4658; (1984) 15 ATR 982 at 1002].

47. The approach adopted by the courts in determining when a loss or outgoing is 'incurred' for tax purposes is derived principally from property and contract law rather than accountancy practice and principles. Indeed, judicial authorities clearly establish that generally accepted accounting principles cannot be substituted for the tests contained in the relevant provisions of the Act. (cf. *FC of T v. James Flood Pty Limited,* supra, at CLR 506-7; *Nilsen Development Laborities Pty Limited & Ors v. FC of T,* supra; *Arthur Murray (NSW) Pty Limited v. FC of T* (1965) 114 CLR 314 at 318 & 320). In *New Zealand Flax*, Dixon J outlined the relationship between jurisprudence and commercial practice in the following terms (supra, at CLR 199):

> 'If there is any ground upon which the plan adopted for conducting the operations of New Zealand Flax Investments Ltd. may be extolled, it must be for the manner in which it illustrates the difficulty of applying the provisions of the Federal income tax law when a transaction takes more than a year to complete and the true profit arising from it cannot be ascertained until it is completed or carried further towards completion than a year allows. In such cases a satisfactory estimate of the position at the end of a year may often be made, <u>but upon commercial principles</u>. If that is done, a suitable provision for future outlay must be made against current receipts or credits. <u>But, under the *Income Tax Assessment Act* 1922-1930, the assessment must begin by taking, under the name of assessable income, the full receipts on revenue account, and only such deductions must be made as the statute in terms allows</u>.' (Underline added)

48. The role of commercial and accountancy practice in the context of taxation law was also succinctly put in the joint judgment of the High Court in *FC of T v. James Flood Pty Ltd* (supra, at CLR 506-7):

> 'Commercial and accountancy practice may <u>assist</u> in ascertaining the true <u>nature and incidence of the item</u> as a step towards determining whether it answers the test laid down by subsection 51(1) <u>but it cannot be substituted for the test</u>.' (Underline added)

49. The courts have on occasions found commercial and accountancy practice relevant and have drawn on accounting principles in ascertaining a correct reflex of a taxpayer's financial position. In such circumstances the courts have recognised the extent of a presently existing liability to pay an amount in the future that is properly referable to each particular income tax year. In doing so the courts have made a conceptual distinction between the whole legal liability to pay in the future and the expense attributable to the income year, recognising the latter as the properly deductible outgoing for taxation purposes (cf. *W. Neville & Co. Ltd v. FC of T* (1937) 4 ATD 187 at 194;

Alliance Holdings Ltd v. FC of T 81 ATC 4637; (1981) 12 ATR 509; *FC of T v. Australian Guarantee Corporation Ltd,* supra). This approach is consistent with the judgment of Dixon J (with whom Rich and McTiernan JJ agreed) in *The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited (Carden's case)* (1938) 63 CLR 108. At CLR 152-3 his Honour said:

> 'The courts have always regarded the ascertainment of income as governed by the principles recognised or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question...
> The tendency of judicial decision has been to place increasing reliance upon the conceptions of business and the principles and practices of commercial accountancy.'

(See also *Hooker Rex Pty Limited v. FC of T* 88 ATC 4392 at 4399; (1988) 19 ATR 1241 at 1248; *Ogilvy and Mather Pty Ltd v. FC of T* 90 ATC 4836 at 4866; (1990) 21 ATR 841 at 876).

50. While Dixon J was speaking of the ascertainment of income for a medical practitioner, the same is true of the ascertainment of expenditure unless precluded by the terms of the Act (cf. *FC of T v. Australian Guarantee Corporation Limited,* supra, per Toohey J at ATC 4649; ATR 992; *Hooker Rex Pty Limited v. FC of T*, supra, per Sweeney and Gummow JJ at ATC 4399; ATR 1248). Dixon J then went on in *Carden's Case* to make his oft quoted statement (supra, at CLR 154):

> 'In the present case we are concerned with rival methods of accounting directed to the same purposes, namely the purpose of ascertaining the true income. I think the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. In other words, the enquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income.' (Underline added)

51. Apart from the general provisions of sections 25 and 51, the Act contains no specific rules as to when income is derived or deductions are incurred in relation swap transactions . In *XCO Pty Limited v. FC of T* 71 ATC 4152; (1971) 2 ATR 353, Gibbs J (as he then was) made reference to using accountancy practice to achieve an accurate reflection of taxable income on such occasions when he said (at ATC 4156; ATR 359):

> 'In the absence of some definite direction in the Act, the Commissioner should, in an assessment of income, adopt the method of accounting which is in fact appropriate to

> the circumstances of the case, or which in other words 'is calculated to give a substantially correct reflex of the taxpayer's true income' (Commissioner of Taxes (SA) v. Executor Trustee and Agency Co of SA Limited (Carden's case) (1938) 63 CLR 108 at p. 154).' (Underline added)

52. The orders of the High Court in *New Zealand Flax Investments* (supra) illustrate the High Court's willingness to attempt a matching of revenue with expenditure of an accounting period as a method of determining so much of the incurrence as was attributable to the income tax period in question.

53. The taxpayer company in that case issued bonds either for cash or payable by instalments subject to interest when fully subscribed. The company covenanted with its bond holders that it would within five years complete the purchase of certain land, grow flax on the land, erect a mill and sell the milled flax. The taxpayer made up its accounts and returns by including as revenue the entire sum representing the bonds sold, whether paid up or not, and, on the other side of its accounts, brought to account provisions for the purchase of the land, its clearing and cultivation, the erection and running of the mill, and the company's obligations to pay interest on the bonds when fully paid and its obligations to pay commission in respect of the placement of the bonds when fully paid.

54. In making the assessment, the Commissioner left standing the revenue side of the account but disallowed the provision for future outlays. The High Court remitted the matter to the Commissioner 'so as to enable him to include only bond moneys received in the accounting periods and to allow whatever part, if any, of the deductions claimed for future interest and deferred commission appears referable to the accounting periods under assessment.' (per Dixon J at CLR 208; See also the orders of Rich J at CLR 193). The Court's reference to the matching principle of accountancy is clear in the following excerpt from the judgment of Dixon J (supra, at CLR 207):

> 'In the present case I regard the obligation to pay interest to bondholders who, within the four years from the date of issue, paid up the amount of the bonds, as a definite liability contingent only on the bondholders meeting their instalments, that is, in the case of the bonds subscribed for in or before the respective accounting periods the subject of assessment. There is no reason why the future liability should not be treated as incurred, if otherwise it were proper to throw it against the revenue items, as it would clearly have been if the full face value of the bonds were included in the assessable income. But I find it difficult to say upon the information before us whether any of this liability should be considered as properly attributable

> to the years in question. There is, I think, no objection to the commissioner's taking into consideration the actual events of the subsequent years in order to see whether, under a method of accounting by which only actual receipts from the bonds are included, the liability for interest would naturally be provided out of revenue from that source accruing in the year when the liability would be met , or whether safe or proper practice required for the purpose an appropriation and retention of part of the sums received in the accounting periods under assessment. In the same way I think that the commissions payable on the sale of bonds but deferred until the receipt of later instalments involve an outgoing 'incurred', but one which does not necessarily and as a matter of course fall into the assessment of the accounting period.' (Underline added)

55. Subsection 51(1) has since been interpreted as being a statutory recognition and application of the matching principle of accounting (cf. *R.A.C.V. Insurance Pty Limited v. FC of T* 74 ATC 4169 at 4181; (1974) 4 ATR 610 at 623).

56. The situation where a presently existing liability relates to more than one accounting period was addressed in *Alliance Holdings* (supra) and *Australian Guarantee Corporation* (supra). Both cases dealt with the question when deductions are available for interest obligations under subsection 51(1) by finance companies under deferred interest debentures (with some differences in the form of the debentures issued in each case).

57. In *Alliance Holdings,* Woodward J of the Supreme Court of NSW held that the finance company taxpayer was entitled in the year of income to deduct a portion of the total interest in accordance with accounting principles. Woodward J rested his conclusion on the basis that during the year of income the finance company had come under a present liability to pay interest in the future, and that being the case, the 'loss or outgoing incurred' in that year could properly be measured by the application of the accruals basis of accounting practice under which the amount of interest was appropriated to the particular year of income. After acknowledging that the accruals accounting method applied by the taxpayer correctly reflected the taxpayer's deductible interest expense and was consistent with generally accepted accounting principles in Australia, his Honour (at ATC 4640; ATR 512-3) made the point 'that the accounting procedure adopted by the taxpayer is a correct one does not force an interpretation of section 51 which the section cannot sustain.' Later (at ATC 4643; ATR 515-6) his Honour said:

> 'The obligation (to pay principal and interest) was created at the time the contract was made. The debt however was not payable until some time in the future...I am satisfied that in respect of the deductions claimed by the taxpayer there was in each relevant tax year a present liability to pay the determined interest at a future date...' (Underline added)

58. The Supreme Court of NSW in *Australian Guarantee Corporation Ltd v. F.C. of T* 84 ATC 4024; (1984) 15 ATR 53 and Full Federal Court on appeal in *F.C. of T. v. Australian Guarantee Corporation Ltd* 84 ATC 4642; (1984) 15 ATR 982 decided that an interest expense was incurred on a daily accruals basis after accepting that a presently existing liability to pay the interest existed from the time the debenture was issued. However, in taking into account generally accepted accounting principles, both Courts decided that the amount of interest which was deductible in the year of income was only that amount which was referable to the year in question on a daily accruals basis.

59. The judgment of Lee J of the Supreme Court referred to the common law rule that interest accrues on a daily basis (and is thus apportionable under the general law in respect of time even if payable only at intervals (cf. *Chow Yoong Hong v. Choong Fah Rubber Manufactory* (1962) AC 834 at 841; see also *Halsbury's Laws of England*, 4th ed., Vol. 32 at p. 53; Vol. 16 at p. 836)). However, the *ratio decidendi* of his Honour's judgment does not appear to be founded on that principle. His Honour acknowledged the authorities which state that accounting principles cannot be determinitive as to when an outgoing is 'incurred' for tax purposes but then stated (supra, at ATC 4033-4; ATR 65):

> 'But a conclusion that, where there is a presently existing liability to pay interest in the future, the amount of interest accruing each year, up to the date of maturity, is "incurred" during the respective years, does not mean that accounting practice is being used as a substitute for the true meaning of "incurred" in subsection 51(1). All it means is that accounting practice is identifying in respect of that liability, which is a present liability to pay the whole of the interest at a future time, the amount which is to be treated as an outgoing "incurred" during each year of income... In this situation it seems to me that accounting practice can be resorted to to identify the extent to which a presently existing liability to be discharged in another year, should be treated as an "outgoing incurred" in the year of income.' (Underline added)

And later (at ATC 4034; ATR 66):

> 'In the present case accountancy practice looks to the existing liability to pay the whole of the interest in the future, and shows the manner in which part of that liability may be appropriately treated as an expense "incurred" during each year of income.' (Underline added)

60. In dismissing the Commissioner's subsequent appeal, the Full Federal Court concluded that the method by which AGC had calculated the amount of accrued interest expense referable to a particular income tax year being in accordance with sound accountancy practice should be accepted. It is noteworthy that Toohey J (in accord with the Supreme Court decision), does not appear to have found it necessary to base his decision on the common law rule that interest accrues on a daily basis. Rather, with regard to the relevance of accountancy practice in determining the appropriate tax expense, his Honour stated at ATC 4650; ATR 992 (with the concurrence of Beaumont J at ATC 4660; ATR 1005):

> 'This Court should be slow to disallow a method of calculating the amount of an outgoing if what is claimed is fairly referable to the year in question. In my view, the amount claimed by the taxpayer as interest on deferred interest debentures for the year ended 30 September 1978 was an outgoing incurred by the taxpayer in the relevant year. It was calculated in accordance with sound accounting practice, designed to give a true picture of the taxpayer's financial operations, and it was an approach not precluded by the language of the Act. It is insufficient objection to that approach to say that it is not known when interest will in fact be paid. The amount claimed as a deduction was, in terms of subsection 51(1), incurred in the relevant year in the sense that the taxpayer subjected itself to a liability which it assessed according to a method fairly designed to reflect the extent of the liability for the year in question.' (Underline added)

(See also the judgment of McGregor J, at ATC 4656-7; ATR 1000-1).

61. These authorities support a concept of deductibility in respect of a presently existing liability to pay amounts in the future on the basis of allocation to a particular year according to accounting principles that properly reflect the extent of the taxpayer's liability for the year. The allocation of a deduction in this way echoes the 'correct reflex' approach enunciated in *Carden's Case* (supra) and permits a deduction for the appropriate portion of a presently existing liability thereby avoiding, in some cases, unwarranted results for a particular income tax period. This is reflected in Toohey's J response to the proposition raised before the Federal Court in *AGC* that the finance company was entitled to an immediate deduction for the interest to be accrued over

the entire loan period. At ATC 4648, ATR 990-1 his Honour remarked:

> 'It may be...that the taxpayer is entitled to a deduction, in respect of the year ended 30 September 1978, of an amount of interest calculated with reference to the entire period that the loan might run. But the taxpayer has not approached the question of deductibility in that way; it has, for the year in question, claimed as a deduction an amount of interest calculated for that year. <u>If such an approach was in accord with sound accountancy practice, designed to give a true picture of the taxpayer's earning and outgoings, I see no reason why the taxpayer should not be allowed a deduction accordingly, unless there is something in the Act that precludes such a course or dictates a different course</u>.' (Underline added)

62. In summary, subsection 51(1) expresses the tests for deduction of (income earning) losses or outgoings, but in certain circumstances accounting principles and practice may be used as a step in determining the extent to which a particular expense satisfies those tests.

63. As stated in paragraph 11 above, taxpayers who enter into swap agreements would use at least one of three different methods to bring swap receipts and payments to account for taxation purposes. The accounting treatment applicable to swap agreements is in part determined by the commercial and economic substance of the transactions to the persons entering into them, and we accept advice that the daily accruals and mark to market methods are adopted by Australian corporations as being currently acceptable market practice. Under those generally accepted accounting principles, payments and receipts under an interest rate swap used to hedge exposures arising from assets or liabilities accounted for at cost must be recognised on a daily accruals basis. On the other hand, swaps used for trading purposes by corporations such as banks may be accounted for on either a daily accruals or mark to market basis.

64. As stated previously at paragraph 36, swap contracts are divisible contracts in the sense that they contain obligations that relate to separate and distinct periods. Provisions relating to the rights of recovery upon event of default (as explained in paragraphs 35 to 42), and the calculation period concept, reinforce the view that swap agreements consist of separate presently existing obligations in each period. The various contractual arrangements lead to a conclusion that a presently existing pecuniary liability to make each payment arises at the commencement date of each calculation period to which a subsequent fixed or floating rate payment relates (cf. *James Flood*, supra, at 506; *Nilsen*, supra, ATC 4034-5; ATR 509; *FC of T v.*

Australian Guarantee Corporation Ltd, supra, at ATC 4650; ATR 992).

65. Further, the events of default provided for in swap contracts such as non-performance, misrepresentation and bankruptcy are not contingencies which may properly be regarded as events of defeasance within the scope of the decision in *Commonwealth Aluminium Corporation Limited v. FC of T* 77 ATC 4151; 7 ATR 376 such that it could be said that the presently existing liability does not arise until the end of the calculation period.

66. Nevertheless, authorities such as *Carden's case, New Zealand Flax, Alliance and AGC* suggest that deductions for swap payments should reflect the extent of the liability that is fairly referable to the year of income. Those authorities demonstrate that the Courts are prepared to accept different bases of tax accounting for different circumstances and look to appropriateness in determining the basis to be adopted. There appears to be a reluctance of the Courts to reject a method that is consistent with business conceptions of what is the true gain derived, or expense incurred, and is reasonable and consistent in its application.

67. It is not appropriate to focus upon the whole of the presently existing liability but rather on the portion that relates to each income tax year that reflects the true financial position of the party. The apportioning of deductions for swap payments on a daily accruals basis over relevant calculation periods is seen as appropriate both in terms of matching income and expenses and providing a correct reflex of a counterparty's taxable income. The matching concept is particularly amenable to interest rate swaps, where there are payments of a similar nature that can flow between the counterparties over a (sometimes considerable) period of time.

68. Daily accruals, based on the matching principle, is the generally accepted accounting method for allocating interest rate swap expenses to relevant periods. In the context of interest rate swaps under which there is a series of payments and receipts under a single agreement, the practice of apportioning payments on a daily accruals basis fairly reflects the extent to which a party is subject to the expense in a particular year of income. Accordingly, deductions allowable under subsection 51(1) for floating and fixed rate payment liabilities should be measured using the daily accruals method. In this context, floating and fixed rate outgoings under both the ISDA Agreement and the AIRS Terms are 'incurred' on a daily accruals basis over the term of each relevant calculation period. As explained later at paragraph 89, no authority has been found to support mark to market as a method for tax accounting for swap receipts and payments.

Timing of Derivation of Swap Receipts in Arrears

69. In determining at what point of time amounts received under a swap contract are assessable under subsection 25(1) it is necessary to determine when the amounts are 'derived'. The Act does not define the word 'derived' and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer. One must therefore look to its ordinary meaning and judicial interpretation.

70. When income is derived depends, in part, upon the nature of the taxpayer and the particular income producing activity. Those factors determine whether the taxpayer ought to bring income to account on a cash or accruals basis. (cf. *Carden's case*, supra). It has become well established that unless the Act makes some specific provision on the point, the amount of income derived is to be determined by the application of ordinary business and commercial principles, and that the method of accounting to be adopted is that which is calculated to give a substantially correct reflex of the taxpayer's true income. (cf. *Carden's case*, supra, at CLR 152-4; *Brent v. FC of T* 71 ATC 4195 at 4200; 2 ATR 563 at 570).

71. It is useful to refer to the judgment of Dixon J (with whom Rich and McTiernan JJ agreed) in *Carden's case*, (supra, at CLR 151-2 & 154) to illustrate this principle:

> 'The question whether one method of accounting or another should be employed in assessing taxable income derived from a given pursuit is one the decision of which falls within the province of courts of law possessing jurisdiction to hear appeals from assessments. It is, moreover, a question which must be decided according to legal principles...But it is, I think, a mistake to treat such a question as depending upon a search for an answer in the provisions of the legislation, a search for some expression of direct intention to be extracted from the text, however much it may be hidden or obscured by the form of the enactment.
> Income, profits and gains are conceptions of the world of affairs and particularly of business...But in nearly every department of enterprise and employment the course of affairs and the practice of business have developed methods of estimation or computing in terms of money the result over an interval of time produced by the operations of business, by the work of the individual, or by the use of capital. The practice of these methods of computation and the general recognition of the principles upon which they proceed are responsible in great measure for the conceptions of income, profit and gain and, therefore may be

> said to enter into the determination or definition of the subject which the legislature has undertaken to tax. The courts have always regarded the ascertainment of income as governed by the principles recognised or followed in business and commerce, unless the legislature has itself made some specific provision affecting a particular matter or question...
> In the present case we are concerned with rival methods of accounting directed to the same purpose, namely the purpose of ascertaining the true income. Unless in the statute itself some definite direction is discoverable, I think that the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. In other words, the inquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's income...Speaking generally, in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a realised or immediately realisable form.' (Underline added)

And later at CLR 156-7 & 159 his Honour said:

> 'The distinction, if not opposition, between the mode of accounting sometimes called the accruals system and that based upon actual receipt and disbursements is widely known. The foundation of the accrual system is the view that accounts should show at once the liabilities incurred and the revenue earned, independently of the date when payment is made or becomes due. It plainly is not applicable to every pursuit by which income is earned...
> The considerations which appear to me to affect any such question are to be found in the nature of the profession concerned and, indeed, the actual mode in which it is practised in a given case...
> For the reasons I have given I think Dr Carden's professional income was properly assessed upon actual receipts.
> To state the case at its lowest, actual receipts formed a basis the choice of which was clearly lawful and proper. The special cases contain very little certainty about the payments of fees, I should have thought that a receipts basis of accounting would alone reflect truly the income and for most professional incomes it is the more appropriate. But to a great degree the question whether income of a particular kind can be properly calculated on one basis alone or upon either, must depend upon the nature of the source of income.' (Underline added)

72. This extract demonstrates that the relevant tax accounting method is a question of law to be determined by the Courts, but where the matter is not specifically addressed by the legislation the Courts

will have regard to accounting and business principles and practices to assist in that determination, with considerable weight being given to what is appropriate in the circumstances. (See also *Henderson v. FC of T* 119 CLR 612; and *FC of T v. Firstenberg* 76 ATC 4141; 6 ATR 297). In addition, it is also clear that the nature of the taxpayer and the activities by which it earns its income, together with the nature of the income itself, are also relevant to the issue.

73. The Courts have been prepared to take a practical approach to tax accounting issues, an example being the judgment of McInerney J of the Supreme Court of Victoria in *FC of T v. Firstenberg,* supra. The Commissioner sought in that case to tax the income of a solicitor, practising on his own account, on an accruals basis. In finding against the Commissioner, his Honour said (at ATC 4155; ATR 314):

> 'I am of the view that the "accruals basis" is, in the case of a practice such as this taxpayer's, an artificial, unreal and unreasonably burdensome method of arriving at the income derived.'

74. Established accounting and commercial principles have been held to be relevant by the Courts in determining when income is derived and their relevance does not diminish even though two or more generally accepted methods may exist in practice. (cf. *Arthur Murray (NSW) Pty Limited v. FC of T*, supra, at 318 & 320; *FC of T v. Australian Gaslight Co.* 83 ATC 4800 at 4806; (1983) 15 ATR 105 at 112). The High Court gave considerable weight to accounting principles in *Arthur Murray* which was concerned with the derivation of earnings and receipts in the context of amounts received in advance of services to be rendered. The decision in that case was also considered helpful by McGregor J. in deciding when deferred interest was incurred for subsection 51(1) purposes in *FC of T v. Australian Guarantee Corporation Limited* (supra, at ATC 4656-7; ATR 1001-1).

75. Swap agreements establish at the commencement of each fixed and floating rate calculation period that, as far as is commercially practicable, swap receipts in defined amounts will become due on dates specified in the Confirmation and the parties to the swap will receive those amounts on or before due dates. On that basis it might be argued that swap receipts are derived at the commencement of each related calculation period (see, for example, *Australian Gaslight Co.*, supra, at ATC 4804-5; ATR 111) unless that would not correctly reflect the taxpayer's true income. Relevant cases demonstrate that the Courts are prepared to accept different bases of accounting for different circumstances and are reluctant to reject a method that is consistent with business conceptions of what is the true gain derived, and is reasonable and consistent in its application.

76. Interest rate swaps are a series of payments of a similar nature flowing between counterparties over a defined period of time under a single agreement. The apportionment of swap receipts over the calculation periods to which they relate using the daily accruals method provides a correct reflex of the amount of swap income derived by a swap party in each year of income consistent with accounting practice and the matching principle. Accordingly, in determining assessable income, fixed and floating rate income derived under interest rate swaps entered into under the ISDA Ageement and AIRS Terms should be allocated on a daily basis over the calculation period to which each payment relates.

77. If payments are set off against each other as described at paragraph 34, section 19 operates to treat the gross amounts of each party as having been derived by each party, the relevant portion being allocated to the related income year on a daily accruals basis.

Swap Fees

78. Under swap contracts, fees are often paid to the party who arranges the swap, usually the financial institution. These fees are deductible when they are due. When a fee accrues due depends on the terms of the contract. A fee payable at the time of entering the contract is generally deductible at that time. However, if the fees are payable at some other point of time, say at the end of the contract it is necessary to determine in terms of the agreement when the amounts are due.

79. Fees paid for the arrangement of a swap contract may be subject to section 82KZM. The section applies, for example, if the fees are charged for the administration of a swap contract that extends for a period of more than 13 months.

Payments and Receipts in Advance

80. While most swap payments and receipts occur at the end of each calculation period (that is, in arrears), there are instances in which payments are made or received in advance (that is, at the beginning of a calculation period).

81. Subject to the swap being a bona fide swap as discussed at paragraphs 85 to 87 of this Ruling, where an accelerated payment is made under either the ISDA Agreement or the AIRS Terms the entire payment is incurred and deductible at the time of payment as

payments made are not subject to any condition subsequent under either the ISDA Agreement or the AIRS Terms (see paragraph 37).

82. Similarly, a swap counterparty who receives such payment derives that income at the time of receipt. The principle in relation to advance payment for services to be rendered in the future, dealt with by the High Court in the *Arthur Murray case* (supra), does not apply to enable a recipient counterparty to accrue swap income past actual receipt. In *Arthur Murray* the Court decided that fees paid in advance for dancing lessons were not assessable income derived during the year of receipt until such time as the actual lessons had, in fact, been rendered and the fees thereby earned. A significant aspect of the decision in *Arthur Murray* was that the taxpayer would have refunded the fees (income) to the payer (student) if the income producing services (the dance lessons) were not performed.

83. Swap payments are not made subject to any condition that would render them refundable on subsequent default by a counterparty. At the time of payment the recipient party is not required to do anything more in order to retain those funds. Nothing further need be done to earn the income. Subsequent non-performance of payment obligations by the receiving party may give rise to an action for compensatory damages under the swap agreement but that is not a contingency affecting the derivation of the relevant income.

84. Swap payments made under a bona fide interest rate swap agreement are not payments 'incurred in return for the doing of a thing...' within the meaning of section 82KZM. Therefore, the advance expenditure rules in 82KZM that spread deductions over the period of a contract that exceeds 13 months do not apply to swap payments.

Bona Fide Contracts

85. This Ruling applies to bona fide interest rate swap contracts. The import is that the deductibility of interest rate swap payments is on the basis, expressed in paragraph 8 of IT 2050, that swap payments are attributable to underlying interest expenses and are therefore on revenue account. Different considerations come into play if an agreement in the form of an interest rate swap truly reflects the provision of finance by a party to another or, conversely, can be seen in substance as an investment. In those circumstances, the arrangement requires close analysis to determine the extent to which so called swap payments are of a capital nature.

86. The following examples serve to illustrate the kinds of transactions that might be regarded as outside the scope of this Ruling:

(1) In substance loan	An accelerated fixed rate payment for the entire swap term is made to a party which is not hedging any underlying interest rate exposure. Regular floating rate payments are then made back to the swap counterparty on terms that reflect a rate of return to that counterparty.
(2) In substance investment	A swap party which is not hedging any underlying interest rate exposure makes regular fixed rate payments and receives one back-end floating rate payment at maturity date on terms calculated to provide a rate of return on the fixed payments.

87. In the context of bona fide swap considerations, the qualification expressed in paragraph 9 of IT 2050 is worth repeating. That is, where two parties enter into an interest rate swap for hedging purposes it would seem usual for those parties to have underlying loans carrying rates of interest which are more or less comparable. If there are substantial differences between the fixed and floating rates of interest at the time the parties enter into the swap then those circumstances require examination to decide whether the swap payments and receipts are truly of a revenue nature.

Application

88. This Office has consistently held the view that swap receipts and payments are derived and incurred on the date on which such receipts and payments are due and receivable or due and payable. The opinions expressed in this Ruling represent a departure from that view in respect of the tax accounting treatment of interest rate swaps. Some taxpayers would have priced and accounted for interest rate swaps for tax purposes on a basis consistent with the Commissioner's previously held view.

89. While some submissions to this Office suggest that a mark to market accounting basis ought to be acceptable for bringing swap receipts and payments to account for tax purposes, no authority has been found to authorise a tax accounting method that involves in part,

a determination of the net present value of future swap receipts and payments.

90. With the above in mind, taxpayers are required to adopt the method described in this Ruling for returning receipts and payments made or received under a bona fide interest rate swap contract as follows:

a) Receipts and payments under all swap contracts entered into on and from the date of effect of this Ruling should be brought to account on the daily accruals basis explained in this Ruling.

b) Taxpayers who previously adopted a due and payable/due and receivable basis may continue to do so for all bona fide swaps entered into prior to this Ruling until those contracts expire; or recalculate payments and receipts under all swaps entered into prior to this Ruling to a daily accruals basis. In these circumstances, taxpayers may seek amendment of previous tax assessments to the extent permitted by section 170.

c) Taxpayers who have previously tax accounted for swaps on a mark to market basis or methods other than daily accruals or due and payable/due and receivable, should recalculate payments and receipts under all swap contracts entered into prior to this Ruling to a daily accruals basis, and seek amendment of previous tax assessments, subject to the limitations imposed by section 170.

d) Paragraph a) above, applies to taxpayers who have been subject to audit action and the audit has been settled on a basis which included a requirement to adopt the due and payable/due and receivable method of accounting for interest rate swaps. Where those taxpayers have continued to account for swaps on a due and payable/due and receivable basis following audit, they may adopt either of the two alternatives set out in pagagraph b) above from the first year of income following the last year audited. Under no circumstances should audit settlements be disturbed.

91. Finally, all dispute cases, all unanswered section 169A requests for rulings and advance opinion requests should be completed in accordance with this Ruling.

Commissioner of Taxation

21 May 1992

ISSN 0813 - 3662

ATO references
NO 92/2288-0
BO

Previously released in draft form as EDR 45

Price $2.70

FOI index detail

reference number
I 1013228

subject references
- allowable deductions
- assessable income
- interest rate swaps
- swaps

legislative references
- ITAA 51(1); ITAA 25(1); ITAA 82 KZM

case references
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