TR 96/22 - Income tax: section 51AD - deductions not allowable if an asset financed by non-recourse debt is used by a tax exempt or other entity

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Taxation Ruling

Income tax: section 51AD - deductions not allowable if an asset financed by non-recourse debt is used by a tax exempt or other entity

other Rulings on this topic

IT 2602; TR 95/30

contents para

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*[*Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (http://law.ato.gov.au) to check its currency and to view the details of all changes.*]

What this Ruling is about

Class of person/arrangement

1. This Ruling discusses the application and interpretation of section 51AD of the *Income Tax Assessment Act 1936* (the Act). It provides a general overview of the provision. In particular, it deals with the following matters:

(a) tax-exempt end users;

(b) the nature of non-recourse finance;

(c) the meaning of 'predominant';

(d) how non-recourse finance is affected by assurances, guarantees, put or call options and the release of securities;

(e) the Commissioner's discretion to treat a debt as if it were not non-recourse debt, and considerations affecting its exercise;

(f) the meaning of 'use';

(g) the meaning of 'control of use'; and

(h) the consequences of section 51AD applying to property in relation to a taxpayer.

2. This Ruling does not discuss the treatment of arrangements where the end-user is not a resident of Australia and the property is, or is to be, used wholly or principally outside Australia or where the

property was, prior to its acquisition, owned, and used or held for use, by the end-user.

Previous Rulings

3. Taxation Determinations TD 92/137, TD 92/138, TD 92/139, TD 92/141, TD 94/1, TD 94/3 and TD 94/4 are withdrawn. To the extent to which our views in those Determinations still apply, they have been incorporated into this Ruling.

Key concepts

4. Where the conditions relating to time of acquisition and non-recourse debt are satisfied, section 51AD applies to property in relation to a taxpayer in either of two broad sets of circumstances. The first, outlined in paragraph 51AD(4)(a), is where a person ('the end-user') holds rights as lessee, and one of the following applies:

(i) that person is a non-resident of Australia and the use of the property is wholly or principally outside Australia; or

(ii) the property is not used exclusively for the purpose of producing assessable income; or

(iii) before the purchase of the property by the taxpayer, it was both owned and used or held for use by the end-user.

5. The second circumstance in which section 51AD can apply, outlined in paragraph 51AD(4)(b), is where a taxpayer owns property but the use of the property for the production, supply, carriage, transmission or delivery of goods or provision of services is effectively controlled by another person ('the end-user'). This applies provided the end-user:

(i) is a non-resident of Australia and the use of the property is wholly or principally outside Australia; or

(ii) does not use the goods produced or services provided by the property solely for the purpose of producing assessable income; or

(iii) derives no income or derives wholly or partly exempt income in producing those goods or providing those services; or

(iv) owned and used the property, or held it for use, before its purchase by the taxpayer.

6. In either of these circumstances, subsection 51AD(10) operates to treat the owner of the property as not having used it for the purpose of producing assessable income, or in carrying on a business for that purpose. The effect is that the owner is denied deductions attributable to the ownership of the property, including depreciation (subsection 54(1), Division 10B, Division 10C and Division 10D; repairs (section 53); interest on borrowings (subsection 51(1)); expenses of borrowing, discharging a mortgage and leasing (sections 67, 67A and 68).

7. This provision, together with Division 16D, is subject to rewrite in plain English form; however, the underlying policy of the legislation remains the same.

Ruling

Tax-exempt end-user

8. A situation that commonly attracts the operation of section 51AD is where an end-user is exempt from tax or is a non-resident of Australia. Typically, an exempt end-user involved in these arrangements is a government body or public authority. See discussion in paragraphs 27 to 31 of this Ruling. A person may be an end-user by virtue of controlling the property. See Example 1.

Control of use

9. A key test in the section, where the end-user is not a lessee, is that the end-user must have control of the use of the property for the production of goods or provision of services. Control of use is effective control of the property. Effective control means day-to-day or de facto control. In determining whether the end-user has de facto control, regard will be had to all the circumstances. These include contractual rights and other rights and obligations arising from the use of the property.

10. A tax-exempt entity can control the use of property for the production of goods or provision of services even though the property is also used by another entity and the tax-exempt entity does not have the actual physical or day-to-day use of the property.

Agency

11. Where the relationship between the exempt body and the taxpayer is one of principal and agent, this relationship will not **of itself** determine the question of who controls the use of the property.

The finding of who has effective control of the property will depend on the facts of the case, including the terms of the agreement.

Non-recourse debt

12. The section only applies where the property is wholly or predominantly financed by non-recourse debt - that is, where non-recourse debt provides more than half of the total cost of acquiring or constructing the property. Debt is non-recourse if the rights of the creditor against the taxpayer (the creditor's recourse) in relation to more than 50% of the principal and interest owed at any time are capable of being restricted to rights against the property, the use of the property, or goods and services produced by means of the property (subsection 51AD(8)).

Recourse

13. The debt is not regarded as non-recourse if, in the event of default by the taxpayer, the rights of the creditor are not predominantly limited to those listed in paragraph 51AD(8)(a), or capable of being so limited. This means the creditor has recourse to assets other than the project property and project cash flows to recover at least half of the principal and interest outstanding.

14. An evaluation of the debt is made on the basis of the net value of the other rights over assets to which the creditor has access. That is, other liabilities ranking ahead of the liability to the creditor, and any restrictions on the exercise of particular rights, must be taken into account to determine the extent to which the creditor can satisfy the debt.

Whole or predominant

15. Our view is that section 51AD does not apply unless a predominant part, being more than 50%, of the cost of acquisition or construction of the relevant property has been financed by non-recourse debt. That is, the rights of the creditor against the taxpayer are limited wholly or predominantly to any or all of the rights listed in paragraph 51AD(8)(a).

Assurances or guarantees

16. Where a taxpayer provides assurances or guarantees in relation to the debt, the debt will be considered non-recourse unless these assurances give rise to additional rights of the creditor against the taxpayer.

Put or call options

17. Put or call options entered into between a taxpayer and a third party over the financed property do not give rise to rights in addition to those described in paragraph 51AD(8)(a). Rights arising from these options constitute rights in relation to the disposal of the whole or a part of the property under sub-subparagraph 51AD(8)(a)(i)(C). Where a put or call option for the asset's market value at the time of exercise exists over other assets, this does not increase the net assets of the taxpayer. See Example 4.

Release of security by creditor

18. Where a creditor initially has recourse to the whole of the assets of a debtor, but later will be restricted to rights relating to the property, the debt is regarded as non-recourse. See Example 5.

Intangible benefits

19. Intangible benefits attributed to the taxpayer such as future tax benefits and carried forward losses cannot be included in the taxpayer's assets when calculating whether debt is non-recourse. Further, even if it is considered unlikely that the individuals involved would fail to pay any debts for reasons such as their professional status, this factor would not prevent the debt from being characterised as non-recourse.

The discretion

20. The Commissioner's discretion in subsection 51AD(9) relates to the level of the taxpayer's financial risk as a borrower. The discretion may be applied in circumstances where financial arrangements, though technically non-recourse, do not in practice restrict the creditor's rights as against the taxpayer. See Example 6.

21. The Commissioner's discretion is not exercised simply on the basis that property is leased to a tax exempt body on commercial terms that would be available to non-exempt lessees, or because a lease can be categorised as an operating lease.

22. If a company with few assets borrows to finance the acquisition or construction of property it may satisfy the tests in subsection 51AD(8). In such a case, if the assets of the parent or another group company, as defined in subsection 80G(1), are put at risk, then consideration is given to the exercise of the discretion in subsection

51AD(9). What constitute sufficient assets and adequate exposure to risk can only be determined on the facts of each particular case.

No reciprocal denial of income where section 51AD applies

23. Where section 51AD applies, it does not operate reciprocally to deny the derivation of relevant assessable income of a taxpayer.

24. Accordingly, any activities of the taxpayer which have the purpose of gaining or producing assessable income or constitute the carrying on of a business for that purpose continue to be so characterised, notwithstanding the application of section 51AD(10), in determining the amount of assessable income derived by the taxpayer.

Date of effect

25. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

General

26. The section was introduced to counter arrangements by which the tax-exempt end-user allowed a non-exempt person to own the property and claim deductions, and passed back these benefits by way of reduced charges to the tax-exempt end-user.

Exempt public bodies

27. The most common case where property is not used for the purpose of producing assessable income is where the end-user is exempt from income tax, for example, where property is leased to a government department or statutory authority.

28. It is envisaged that an entity which controls or uses the asset may be tax-exempt by virtue of paragraphs 23(d),(e) or (ea), which exempt the income of municipal corporations, public educational institutions or public hospitals from tax.

29. In addition, an entity is exempt from income tax if it is a State or Territory Body (STB) for the purposes of Division 1AB of Part III of the Act (section 24AM). An entity is an STB if it is owned by one or

more government entities; or if it has been established by legislation and a government entity either receives its profits or assets on winding up, has the power to appoint its governing person, or can direct its governing person; or if government entities hold all legal and beneficial interests in it and all rights to appoint, dismiss or direct its governing person (sections 24AO to 24AS).

30. An STB may be an excluded STB either as prescribed by the regulations or by virtue of the specific exclusions in section 24AT. However, although the income of a prescribed excluded STB is taxable, it is treated as exempt for the purposes of section 51AD (subsection 51AD(21)).

31. Section 51AD applies to an arrangement where an exempt end-user has control of the use of an asset (refer to subparagraph 51AD(4)(a)(ii), and sub-subparagraphs 51AD(4)(b)(ii)(B) and 51AD(4)(b)(ii)(C)). See Example 1.

Use

32. Provided the conditions relating to non-recourse debt are satisfied, section 51AD applies where the end-user holds rights under a lease (including an arrangement which gives rights to use the property) **and** where the property is used in the manner specified in subparagraphs 51AD(4)(a)(i), (ii) and (iii) (see paragraph 4 above). Alternatively, where the property is not leased but is used in the production, supply, carriage, transmission or delivery of goods or the provision of services, and the end-user effectively controls the relevant use of the property, paragraph 51AD(4)(b) applies. A common feature of both paragraphs is the concept of use.

33. The courts have considered and applied the ordinary meaning of the word 'use' in *Transfield Kumagai Contracting Pty Ltd v. FC of T* 90 ATC 4960; (1990) 21 ATR 1003. In the sales tax context, Grove J found that the ordinary meaning of the word 'use' is 'purpose served or object or end', and this is 'not restricted to any notion of actual physical use' (at ATC 4966; ATR 1009). Similarly, in *Air Liquide Australia Ltd v. FC of T* 96 ATC 4468; (1996) 32 ATR 510, Heerey J applied two of the meanings of 'use' given in the *Macquarie Dictionary* to determine whether the taxpayer had granted its customers rights to use gas storage vessels in the context of investment allowance provisions. The two meanings applied were (1) 'to employ for some purpose' and (2) 'to avail oneself of'. His Honour held that the customers were using the vessels under rights granted by the taxpayer since the storage vessels were integral to the customers' operations and there was a commercial benefit conferred on the customers by the possession of the storage vessels.

34. A person may use property although it is being occupied by another person. In the context of exemption from local government rates, the High Court addressed aspects of the use of land by public bodies in *Ryde Municipal Council v. Macquarie University* (1978) 139 CLR 633; (1979) 23 ALR 41. In that case, the majority of the High Court found that Macquarie University was using solely for its own purposes land on its campus that had been leased to various shops and banks, which was consequently exempt from rates. Although the University was not occupying the land, it was held to be using it to provide facilities for its students and staff. Gibbs ACJ said at 139 CLR 638; 23 ALR 45 that:

> 'A person who owns land may be said to use it for his own purposes notwithstanding that he permits someone else to occupy it, even under a lease. That is almost beyond argument when the owner's purpose is to acquire income'.

He added that an 'indirect use' of land by an employer who provides it as a residence for the use of her employees will also be regarded as a use by that employer (at 139 CLR 638; 23 ALR 45).

35. *Ryde* was applied in *Attorney-General (ACT) v. Commonwealth of Australia* (1990) 26 FCR 82; 95 ALR 739, in which the Full Federal Court in a joint judgment upheld a declaration that land on which a private hotel was situated was being used by the Commonwealth and was thus national land. The Commonwealth was held to use the land since it retained certain rights, including the right to dictate who would be accommodated and at what tariff; it received a return on the capital it had originally invested in the form of an annual payment made by the company for its use of the premises; and the company had no right to use the hotel for any purpose other than the accommodation of those it was required or permitted by the Commonwealth to accommodate. 'The Commonwealth need not have been the sole user of the land, nor need it have been in occupation of it' in order to reach this conclusion (at 26 FCR 93; 95 ALR 750).

36. These cases demonstrate that property may be simultaneously used by more than one entity, and that a person may use property notwithstanding that someone else is using or occupying it. The view that a taxpayer who has day-to-day operation has exclusive use is not correct.

Right to use

37. For the purposes of paragraph 51AD(4)(a) a 'lease' is defined as including a grant of a right to use the property under an arrangement (subsection 51AD(1)). The conferring or granting of a right to use has been interpreted widely by the courts, particularly where supported by contractual documentation.

38. A right to use has been considered as the receipt of a benefit. In *Air Liquide*, Heerey J found that the taxpayer, by restricting its own rights to retake possession of gas storage vessels, and charging a monthly fee referable to the continued presence of the vessel on the customers' premises, had granted its customers rights to use the vessels. His Honour found that:

> '...the "genesis" and objectively the "aim" of [the monthly fee] ... was to confer on the customer some practical commercial benefit from the presence on the customer's premises of the VIV. That benefit can in my opinion be properly characterised as "use" by the customer of the VIV pursuant to the rights granted by Air Liquide.' (at ATC 4473; ATR 515)

39. A person may have a right to use property in the relevant sense although another person is the lessee of the property, has physical control of the property through its employees, and retains the right to use the property for that person's own purposes. In *Hamilton Island Enterprises Pty Ltd v. FC of T* 82 ATC 4302; (1982) 13 ATR 220, the Full Federal Court disallowed an investment allowance deduction under section 82AF in respect of helicopters which were leased by Hamilton Island Enterprises Pty Ltd ('Hamilton Island') from a leasing company and then chartered, giving a right to use, to Sea World for joy rides. Bowen CJ, Deane and Fisher JJ examined the features of the arrangement under which Hamilton Island supplied helicopters and pilots for charter flights, and was entitled to use the helicopters on more lucrative work away from Sea World if this became available. Advertising and other publicity would refer to flights as being operated by Sea World; and Sea World would pay for costs such as advertising, staff to sell tickets, and construction of a helipad and hangars for the helicopters. Their Honours considered the overall effect of the arrangement and came to the conclusion that Sea World was entitled to use the helicopters in the relevant sense (at ATC 4307; ATR 226). The effect of the decision is that Sea World had a right to use the helicopters at the same time that Hamilton Island was using them.

Control of use

40. Control of the use of property under paragraph 51AD(4)(b) can include actual use of the property, or can mean exerting control over the way in which another person uses the property. In some situations, while not having day-to-day use or physical use of the property, a tax-exempt body may control the use of the property; for example, if it has the power to take over control of daily operations at any time.

41. If a tax-exempt body controls the use of the property, this will trigger the operation of section 51AD. The operation of the section cannot be prevented simply by showing that the property is also being used by another person, as 'use' and 'control' involve separate considerations.

42. Subsection 51AD(1) defines control as meaning effective control. Effective control is a broad test that is not limited to the strict legal rights resulting from agreements or arrangements but includes any other arrangements, including financial ones, that could affect the question of who controls the use of the property for the production of goods or provision of services. The finding of who has effective control will depend on the facts of a particular case.

43. Although Taxation Ruling IT 2602 deals specifically with power stations its principles are helpful in examining other enterprises. The following elements, taken by analogy from that Ruling, may assist in determining whether a government entity has control of property:

- staffing arrangements - if staff operating the property are employees of the government authority, this is a strong indication that the government authority has effective control. Alternatively, if the staff are answerable to the taxpayer and sufficiently experienced to be capable of operating the property without such supervision, the inference may arise that the taxpayer has control;
- who bears the financial risks of the project. This is not a separate test of control of use of the property, but may provide an indication of effective day-to-day control. However, if the end-user has no lease or right to use, but rather an agreement only to provide services for the operation of a facility, and that operation involves no significant day to day functions, the financial arrangement, may be a determinative factor: for example, computer operated high tension transmission lines, the use of which is monitored at a control centre;
- where the taxpayer receives a guaranteed rate of return from an agreement, so that the return is the same whether the property or service is used or not used, this may indicate that control lies with someone else. Receipt of guaranteed income from an exempt entity for the provision of a service to that exempt entity, where the taxpayer uses the property and where the income is just sufficient to cover expected outgoings and to provide a return to the taxpayer, would make it evident that the exempt entity has de facto control of the property; and

- reversion of the property to the government authority after a certain number of years, or an option for the government authority to acquire the property at a future time, may amount to an attempt by the government to acquire property without the need to raise finance directly, with the transfer of tax benefits to the taxpayer.

44. Further indicia of control include, for example, situations where a tax-exempt entity has very broad step-in rights beyond emergency intervention; or where a tax-exempt entity has any right to dictate issues such as who will occupy the property, what activities will take place there, and on what terms (see *Attorney-General (ACT) v. Commonwealth of Australia* (1990) 26 FCR at 93-94; (1990) 95 ALR at 750-751).

45. Control is examined in terms of the use of the whole property and not any more limited part of the use that may be provided under a contract between the parties. For example, a maintenance agreement does not usually cover the whole use of property to produce goods or services. The nature of the use extends to factors outside that one agreement and would cover other arrangements such as rights to occupy, fees for use and the actual and contractual obligations between the end-user and the owner of property.

46. Where a taxpayer contracts for the use of property and the provision of services, with the services being the essential part of the contract rather than the use of the property, then the determinative matter for consideration is the nature of control over the services provided (in relation to property). An example of this is the provision of plastic garbage bins and a contract for the removal of garbage where the substantial part of the contract is the provision of services and the plastic bins (property) are a minor element.

47. The central aspect is who has de facto **control** of the use of the property.

Non-recourse debt

48. Broadly, a non-recourse debt is one where the lender's rights **as against the taxpayer** in the case of default in repayment are effectively limited to actual legal rights against or in relation to the property, or against income generated or goods produced or services provided by the property. This is the situation dealt with in paragraph 51AD(8)(a). Generally, this provision is satisfied by a contractual limitation of the rights of the creditor against the assets of the taxpayer to those specifically listed in paragraph 51AD(8)(a). In other words the lender would not have the usual rights of access to the general assets of the taxpayer in any action for recovery of the debt.

49. However, subsection 51AD(8) further contemplates practical limitations on the rights of the creditor as against the taxpayer to recover in the event of default in repayment of principal or interest, by reference to the assets or any arrangements of the taxpayer: paragraph 51AD(8)(b). Paragraph 51AD(8)(b) extends paragraph 51AD(8)(a) to situations where legal rights are, in the opinion of the Commissioner, capable of being limited or changed in a practical sense. Thus, by virtue of paragraph 51AD(8)(b) a debt will be treated as a non-recourse debt if the only asset of the taxpayer is the property or a right to receive lease income from the property, regardless of whether there is a contractual or formal limitation of the rights of the creditor as against the taxpayer. For example, where the taxpayer is a special purpose vehicle (e.g., a company set up specifically for the one purpose or venture), the rights of the creditor are limited to the property, being the only asset of the taxpayer - subparagraph 51AD(8)(b)(i). Alternatively, certain other arrangements could have the effect, in the opinion of the Commissioner, of similarly limiting the real risk of the borrower and thus may also cause a debt to be treated as a non-recourse debt - subparagraph 51AD(8)(b)(ii).

50. Even if the right gives the creditor additional recourse, the debt may still be non-recourse if the right has a limited value. The Commissioner needs to be satisfied that the net value of the assets of the company is sufficient to meet at least 50% of the outstanding principal and interest under the debt. See Example 2.

51. Paragraph 51AD(8)(c) operates in the alternative to paragraphs 51AD(8)(a) and (b) where the assets of the taxpayer generally are not available to discharge the debt. This occurs where a creditor does not have full access to the assets of the taxpayer in an action for recovery of the debt. For example, if all other assets (other than assets given as security for the payment of other debts) were not available to the creditor, they would not be available to the creditor in relation to its debt.

52. Assets held by companies owned or controlled by the taxpayer are not themselves assets of the taxpayer against which a creditor could have recourse and cannot be taken into account for the purposes of this test. Nor can a creditor have recourse against the assets of a trust of which the taxpayer is a beneficiary, unless the taxpayer is absolutely entitled in possession to the trust property.

Alternative view

53. The view has been put forward that if a lender has legal rights of recovery against all the assets of a company, whatever they may be from time to time, then the loan cannot be non-recourse even though the property is in fact the only asset of the company. This

construction would, however, seem to deny paragraph 51AD(8)(b) any effective operation. Our view is that under paragraph 51AD(8)(b) the Commissioner would conclude that where the only assets of the taxpayer are the project assets, the rights of the creditor are capable of being so limited.

Assurances and guarantees

54. If a third party gives an assurance or guarantee that a taxpayer will pay the amounts due under a loan, it is necessary to determine whether, as a result of the assurance or guarantee, the creditor has additional rights against the taxpayer in the event of default. If the assurance or guarantee does not add to the resources of the taxpayer, it will not give recourse **as against the taxpayer** to any rights additional to those specified in paragraph 51AD(8)(a) as being non-recourse rights. Accordingly, where the creditor has a right to sue a third party, the assurance or guarantee will not give the creditor additional recourse against the taxpayer.

55. If a taxpayer has a right to seek additional income or resources from a third party in the event of a default on the loan payments, consideration will need to be given to whether that right comes within subparagraph 51AD(8)(a)(iii), namely, whether it is a right 'arising out of any arrangement relating to the financial obligations of the end-user of the property towards the taxpayer, being financial obligations in relation to the property'. Such a right is itself specified in paragraph 51AD(8)(a) and so gives no additional recourse to the creditor.

Whole or predominant

56. The word 'whole' and the word 'predominant' describe to what extent the legislation requires the debt to be non-recourse. It is either the complete debt or alternatively some lesser amount that is to be tested. The word 'predominant' is not defined in income tax law. Therefore, it bears its common meaning. *The Macquarie Dictionary* defines 'predominant' as:

> '(1) having ascendancy, power, authority, or influence over others ...
>
> (2) prevailing.'

57. To determine whether a predominant (as defined above) part of the cost of acquisition or construction of the property has been financed by non-recourse debt requires consideration of whether non-recourse debt exceeds or prevails over other sources of finance. That is, in quantitative terms whether it is more than 50% of the cost of the property.

58. Accordingly, for the section to apply, the property must be predominantly (being more than 50%) financed by non-recourse debt. Debt is non-recourse if the creditor's rights are predominantly (more than 50%) limited to those listed in paragraph 51AD(8)(a). If the creditor has the right to recover at least 50% of the principal and interest owing at any time through rights other than those listed at paragraph 51AD(8)(a), the debt is not predominantly non-recourse.

Alternative view

59. The alternative view as to whether the cost of acquiring or constructing a property is predominantly financed by non-recourse debt is that subsection 51AD(8) operates in two stages where the greater than half test is used. Under this view, the section applies to an arrangement where more than 50% of the cost of purchasing or constructing a property is financed by debt and the rights of creditors in relation to more than 50% of this debt are restricted to rights associated with the property.

60. By way of illustration, if a property costing $100 is financed by 80% debt ($80) and 20% equity ($20), of the 80% debt ($80), $41 is non-recourse and $39 is recourse. Based on the view in paragraph 59 above, the predominant financing of the cost of the property is debt ($80) and the predominant part of the debt is non-recourse debt ($41). Therefore, the alternative view is that subsection 51AD(8) would be triggered.

61. This interpretation is not our view. Our view is that although the debt is more non-recourse ($41) than recourse ($39), section 51AD has no application, as the non-recourse debt ($41) is not the predominant part of the cost of financing the arrangement. The major part of the cost is the equity $20 plus the $39 recourse finance. Our preferred view is that the use of the terms 'whole or a predominant part' and 'wholly and predominantly' are used to test different aspects, the first expression referring to the aspect of the cost of acquisition or construction of the property and the second expression referring to the aspect of whether or not the debt is non-recourse. This interpretation is generally beneficial to taxpayers, and is in keeping with the policy behind the provision.

Recourse

62. The breadth of paragraph 51AD(8)(a) is largely in keeping with generally defined concepts of non-recourse debt where a creditor only has recourse to the property or its proceeds or to the use of the property or to the goods produced or services provided by that property and security over that property, but no further recourse

against the borrower. The phrase 'wholly or predominantly' is used in determining whether the rights of the creditor or creditors as against the taxpayer in the event of default in the repayment of principal or payment of interest are mainly limited to any or all of the rights in relation to the property as listed in paragraph 51AD(8)(a). The next two paragraphs extend the scope of this interpretation by expressing further and alternative limitations on creditors' rights which are offensive to the provision (paragraphs 51AD(8)(b) and (c)).

63. To determine whether debt is non-recourse, the value of any assets of the taxpayer, other than rights in relation to the financed property, must be reduced by any other higher ranking liabilities. Such liabilities have a higher claim on the assets than the claims of the creditor. Accordingly, where a taxpayer has liabilities ranking ahead of the liability to the creditor, the assets available to the creditor will only have their residual value after allowing for prior ranking liabilities.

64. Intangible benefits such as goodwill, which typically fluctuates from time to time, may be difficult to value for the purposes of determining whether a debt is non-recourse. Section 51AD looks to the rights of the creditors against the taxpayer in the event of default, not to the likely intangible assets that the creditors may realise on the sale of the business or to those which are not realisable, such as future tax benefits. See Example 7.

The discretion

65. Subsection 51AD(9) gives the Commissioner of Taxation the discretion to treat the debt as if it were not a non-recourse debt 'if he is of the opinion, having regard to the circumstances in which the debt was, or debts were, incurred and any other matters that he thinks relevant, that it would be reasonable to do so'.

66. This does not give the Commissioner of Taxation a general discretion to dispense with the section; the question is only whether it is reasonable to treat debt as if it were not non-recourse debt.

67. The Commissioner's discretion will not be exercised simply on the basis that a lease can be categorised as an operating lease, because under the legislation the test of whether section 51AD applies is measured by the rights of the creditor as against the taxpayer in the event of default, and the Commissioner's discretion under subsection 51AD(9) also relates to the taxpayer's financial risk.

68. The purpose of the discretion is to allow for situations where an application of the test in subsection 51AD(8) in the opinion of the Commissioner is unreasonable having regard to the fact that although

the debt is technically non-recourse it is clear that there was no intent to restrict the rights of the creditor.

69. If the assets of another group company are put at risk, then consideration is given to the exercise of the discretion in subsection 51AD(9). See paragraph 22 above. What constitute sufficient assets and adequate exposure to risk can only be determined on the facts of each particular case. See Examples 2 and 6.

No reciprocal denial of income where section 51AD applies

70. Subsection 51AD(10) provides that where the section applies, 'the taxpayer shall be deemed not to have occupied or used the property, or held the property for use, at that time, for the purpose of producing assessable income or in carrying on a business for that purpose'. The effect is that depreciation and other capital allowances, and other deductions associated with the acquisition or use of the property, such as interest, are not allowable.

71. The deeming effect of subsection 51AD(10) is a 'statutory fiction' in the sense described by Griffith CJ in *Muller v. Dalgety & Co Limited and Another* (1909) 9 CLR 693 at 696. That fiction exists only to the extent necessary to give effect to Parliament's intention. The explanatory memorandum to the Bill which proposed section 51AD said that subsection 51AD(10) 'will operate to disallow deductions attributable to the ownership of property to which section 51AD applies. It will do this by stipulating that such property is to be taken as not being used or held for use by the taxpayer for the purpose of producing assessable income or in carrying on a business for that purpose.'

Examples

Example 1 - control by tax-exempt entities

72. A public infrastructure asset is acquired by an Australian partnership, Auspart. Auspart seeks to claim deductions on the asset. Further facts are that:

- all the partners equally contribute equity amounting to 20% of the cost of the asset into the partnership;
- Auspart borrows 80% of the cost of the asset. The loan funds come from a State government financing entity. The creditor, in the event of default, only has recourse to the asset;

- Auspart enters into an agreement under which the asset will be managed and operated by a tax exempt corporatised entity, Exemptco. Exemptco was previously a branch of a State government and is wholly owned, financed, and fully guaranteed for debts by that State government;
- Exemptco guarantees that Auspart will receive adequate funds to meet its payment obligations in respect of the asset and that it receives a minimum rate of return; and
- Exemptco (corporatised entity) will receive an annual management fee from the Australian partnership for managing the asset. Any excess profits will remain in Exemptco.

73. Section 51AD applies to this arrangement because Exemptco, a tax exempt company, manages and operates the asset, and so effectively controls the use of the asset (sub-subparagraphs 51AD(4)(b)(ii)(B) and (C)).

74. The acquisition of the asset by Auspart is financed by non-recourse debt because the guarantees do not represent substantial other assets of the taxpayer. The guarantees are rights arising out of an arrangement relating to the financial obligations of the end-user of the property (Exemptco) towards the taxpayer (Auspart), being financial obligations in relation to the property. Accordingly these rights come within subparagraph 51AD(8)(a)(iii) and are not additional assets which can be taken into account in applying paragraph 51AD(8)(b).

Example 2 - non-recourse debt and use of undertakings to pay

75. Specialco, a special purpose entity, is incorporated to acquire assets using finance provided by Bigbank and lease those assets to another entity, Leaseco. Other features are that:

- Specialco has 3 equal shareholders. One-third of the shares are held by C (unrelated company), one third by D and one-third by E; and
- D also holds 51% of the shares in Leaseco.

76. D has entered into an undertaking with Specialco under which D unconditionally and irrevocably agrees to pay Specialco on demand any and all amounts which are at any time due to Bigbank which Specialco fails or determines it is unable (for any reason) to pay Bigbank from time to time. Apart from a comparatively small amount of paid up capital, Specialco's other assets are only the leased assets,

rights arising from the lease of the assets and other rights related to the assets.

77. For the debt not to constitute non-recourse debt, the ATO would need to be satisfied that:

- the undertaking to pay would be enforceable by Specialco; and
- D must hold directly sufficient assets, taking into account liabilities ranking ahead of the liability to Specialco and would at all times hold sufficient net assets accessible to the creditor to provide at least 50% of the principal and at least 50% of any interest due to Bigbank at any time.

78. Furthermore, assets not held directly by D would not be taken into account. In determining the net assets of D for these purposes, the assets held by Leaseco would not be taken into account, as they are not assets directly held by D. They would, in any event, prejudice the effect of the undertaking if it depended on them, for the undertaking would then be a right in relation to the property or in relation to the obligations of the end-user in relation to the property, rather than an independent asset.

79. On this basis, the debt provided by Bigbank to finance the acquisition of the leased assets by Specialco does not constitute non-recourse debt for the purposes of subsection 51AD(8). In addition, if the provisions of subsection 51AD(8) had been satisfied in this case, the discretion in subsection 51AD(9) would not have been exercised, as D was not the sole shareholder in Specialco.

Example 3 - non-recourse debt and indirect finance

80. A acquires land and constructs an office building. A borrows 80% of the cost of construction through a loan from the builder for the construction period. That loan is only available because there is a second loan arranged, to pay out the first loan on completion of construction. The second loan is only available because there is a third loan arranged, to pay out the second loan at the expiration of its term (with an alternative being the acquisition of the property by the third lender).

81. In these circumstances, the cost of acquisition or construction of the building is financed directly or indirectly by all three loans. Construction is financed directly by the first loan, and at least indirectly by the second loan. Construction is also financed at least indirectly by the third loan, if it is made, even though a sale to the lender was an alternative.

82. It is not sufficient for the purposes of subsection 51AD(8) to look at any one debt; each of the three debts is taken into account in determining whether the finance is non-recourse debt.

Example 4 - non-recourse debt and put or call options

83. A company, X Co, incorporates a special purpose subsidiary company, Y Co (the taxpayer), whose sole purpose is to finance the construction, ownership and subsequent lease of a commercial building to a tax exempt body for a term of 10 years. To finance the cost of construction, the taxpayer borrows money from Bank Co. The terms of the loan stipulate that in the event of default in the repayment of principal or payment of interest by Y Co, Bank Co has full recourse to all of the assets of Y Co.

84. Y Co then enters into an arrangement with a third party, Z Co, who is not an associate of either X Co or Y Co. Under that arrangement, Y Co (the grantee) pays an option fee to put the property to Z Co (the grantor) at the time an event of default by Y Co occurs in meeting its loan obligations to Bank Co. The consideration received by Y Co on exercise of the option will be used to discharge the debt to Bank Co.

85. The rights of Bank Co as against the taxpayer Y Co are limited in terms of subsection 51AD(8). Firstly, Y Co, being a special purpose company, only has assets that comprise the property and the income generated by the use of that property. The rights of Bank Co as against Y Co are therefore capable of being limited to the rights in subparagraph 51AD(8)(a)(i) and so subparagraph 51AD(8)(b)(i) applies.

86. Secondly, any argument that the money that may be paid by Z Co upon the exercise of the put option by Y Co, is an additional asset of Y Co to which Bank Co can have recourse, is incorrect. The rights arising from the put option are merely rights to secure disposal of the property at a predetermined price, and amount to a further right over the project asset rather than further rights of the creditor against assets of the taxpayer.

87. The option on exercise merely operates to secure the grantor's agreement to acquire the property of Y Co (the grantee).

Example 5 - release of security

88. A taxpayer with substantial assets, Largeco, finances the acquisition cost of plant predominantly with a loan from Lendco. The property is leased to a tax exempt body for 10 years.

89. The debt principal is repayable in 10 years and is secured against all the assets of Largeco. Under the arrangement between Largeco and Lendco, Lendco agrees to release the security over all the assets apart from the leased property at the end of the second year of the lease provided no default event occurs.

90. In these circumstances, the rights of Lendco as against Largeco are limited in terms of paragraph 51AD(8)(a) or are capable of being limited as mentioned in paragraph 51AD(8)(b). The debt constitutes non-recourse debt for the purposes of section 51AD.

Example 6 - indirect finance not by non-recourse debt

91. The following is an example where the acquisition of property would not be considered to be financed by non-recourse debt:

(a) Topco, a company with substantial net assets, borrows on a full-recourse basis and then on-lends those funds to a wholly owned subsidiary company, Subco. Topco and Subco are group companies for the purposes of section 80G.

(b) The funds are then used by Subco to acquire property to which, if the non-recourse financing conditions of subsection 51AD(8) are satisfied, section 51AD would apply.

92. In terms of paragraph 51AD(8)(b), the intermediate intra-group loan is technically a non-recourse debt, if Subco is a special purpose company with no assets other than the property. Because the company group comprising Topco and Subco is at risk for all of its substantial assets, the discretion in subsection 51AD(9) could be exercised to treat the rights of the creditor as not being, or capable of being, so limited, provided that the net assets (after taking into account prior ranking creditors) of the companies forming a group for section 80G purposes would amount to at least 50% of the outstanding principal and interest in an event of default.

93. Accordingly, section 51AD does not apply to this arrangement, where the discretion is exercised.

Example 7 - recourse to other assets

94. A partnership of individuals acquires a building which is leased to a tax-exempt government entity. 80% of the cost of the building was financed by loans taken out by the partnership. Section 51AD would apply unless the individuals had sufficient net assets, other than assets listed in subparagraph 51AD(8)(a)(ii), directly accessible to the creditors to pay half of the principal and interest due at any particular

time. In applying this test, the Commissioner would only have regard to assets held directly by the taxpayer, not to assets held by associated companies or trusts, as these are separate taxpayers.

95. It is not accepted that intangibles such as the professional status and standing of the individuals, the capitalised value of a stream of income or the equity the individuals have in the property are other assets for section 51AD purposes.

Detailed contents list

96. Below is the detailed contents list for this Ruling:

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ATO references
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- exempt end-user
- leases
- non-recourse finance
- use or control
- wholly or predominantly

legislative references
- ITAA 24AM
- ITAA 24AO
- ITAA 24AS
- ITAA 24AT
- ITAA 51(1)
- ITAA 51AD
- ITAA 51AD(1)

- ITAA 51AD(4)
- ITAA 51AD(4)(a)
- ITAA 51AD(4)(a)(i)
- ITAA 51AD(4)(a)(ii)
- ITAA 51AD(4)(a)(iii)
- ITAA 51AD(4)(b)
- ITAA 51AD(4)(b)(ii)
- ITAA 51AD(4)(b)(ii)(B)
- ITAA 51AD(4)(b)(ii)(C)
- ITAA 51AD(8)
- ITAA 51AD(8)(a)
- ITAA 51AD(8)(a)(i)
- ITAA 51AD(8)(a)(i)(C)
- ITAA 51AD(8)(a)(ii)
- ITAA 51AD(8)(a)(iii)
- ITAA 51AD(8)(b)
- ITAA 51AD(8)(b)(i)
- ITAA 51AD(8)(b)(ii)
- ITAA 51AD(8)(c)
- ITAA 51AD(9)
- ITAA 51AD(10)
- ITAA 51AD(21)
- ITAA 53
- ITAA 54(1)
- ITAA 67
- ITAA 67A
- ITAA 68
- ITAA 80G(1)
- ITAA 82AF
- ITAA Pt III Div 1AB
- ITAA Pt III Div 10B
- ITAA Pt III Div 10C
- ITAA Pt III Div 10D
- ITAA Pt III Div 16D

case references

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- Attorney-General (ACT) v. Commonwealth of Australia (1990) 26 FCR 82; 95 ALR 739
- Hamilton Island Enterprises Pty Ltd v. FC of T 82 ATC 4302; (1982) 13 ATR 220
- Muller v. Dalgety & Co Limited and Another (1909) 9 CLR 693
- Ryde Municipal Council v. Macquarie University (1978) 139 CLR 633; (1979) 23 ALR 41
- Transfield Kumagai Contracting Pty Ltd v. FC of T 90 ATC 4960; (1990) 21 ATR 1003