

TR 1999/D13 - Income tax: advance payments made under swap agreements

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Draft Taxation Ruling

Income tax: advance payments made under swap agreements

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling is about the application of section 82KZM of the *Income Tax Assessment Act 1936* (the 1936 Act) to payments made under a swap; a swap being an agreement or arrangement involving an exchange of cash flows on predetermined conditions. This Ruling also addresses the assessability of advance payments made under a swap to the counterparty under subsection 25(1) of the 1936 Act or section 6-5 of the *Income Tax Assessment Act 1997* (the 1997 Act).

Class of person/arrangement

2. The class of arrangements to which this Ruling applies is a swap, being an agreement or arrangement involving an exchange of cash flows on predetermined conditions. Therefore, this Ruling applies to a class of arrangements that is broader than the class of arrangements to which Taxation Ruling IT 2682 applies.

3. The class of persons to which this Ruling applies is taxpayers who claim a deduction under subsection 51(1) of the 1936 Act or section 8-1 of the 1997 Act for advance payments made under a swap, and taxpayers to whom advance payments have been made under a swap.

Previous Rulings

4. This Ruling replaces the third and fourth sentences of paragraph 6 and the whole of paragraphs 82, 83 and 84 of IT 2682.

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To the extent replaced, those paragraphs or parts thereof will be withdrawn on finalisation of this draft Ruling.

Ruling

Swap payments paid in advance

5. Where expenditure by a party to a swap (other than 'excluded expenditure' as defined in section 82KZL) consists of a payment made under the swap agreement, which is incurred in return for the counterparty making a series of payments under the swap agreement that are not to be wholly made within the period of thirteen months from the day on which the expenditure is incurred, the payment is subject to the operation of section 82KZM provided that the other requirements for the operation of that section are met.

Swap payments received in advance

6. A payment made under a swap to the counterparty in advance of the counterparty's making its payments (also called an accelerated payment) is assessable to the counterparty under subsection 25(1) of the 1936 Act or section 6-5 of the 1997 Act in the income year in which the payment is received.

Date of effect

7. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers who entered into swap agreements before the date of issue where those swap agreements were covered by the terms of IT 2682. Where, however, a claim for an advance swap payment has been made in accordance with the terms of IT 2682 the Commissioner will not allow a further claim in relation to the same payment under section 82KZM without disallowing the earlier claim. Also, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Swap payments paid in advance

8. Section 82KZM, the operative provision of Subdivision H of Division 3 of Part III of the 1936 Act, modifies the operation of

section 51 of the 1936 Act and section 8-1 of the 1997 Act in relation to the timing of deductions for expenditure meeting the requirements of the section.

9. The effect of section 82KZM is to spread a deduction for expenditure evenly over the income years comprising an 'eligible service period' not exceeding 10 years. The expenditure to which section 82KZM applies is defined by the consideration for which it is incurred. Specifically, the section applies where the expenditure (other than 'excluded expenditure' as defined in section 82KZL) was incurred under an agreement entered into after 25 May 1988 'in return for the doing of a thing under the agreement that is not to be wholly done within 13 months after the day on which it is incurred'.

10. A swap involves the parties exchanging cash flows on predetermined conditions including a specified term. The revenue payments which make up each party's cash flow relate to that term or a period of that term. Furthermore, the payments made by each party are incurred in return for the counterparty's making their payments.

11. Where a swap agreement provides for one party to make an advance payment in relation to a future period over which the counterparty will make a series of payments, the advance payment is incurred in return for the counterparty's making their payments over that period under the swap agreement. If the period exceeds 13 months the advance payment is 'incurred in return for the doing of a thing under the [swap] agreement that is not to be wholly done within 13 months after the day on which it is incurred'.

12. In these circumstances, section 82KZM applies to spread the deduction for the advance payment evenly over the period to a maximum of 10 years.

Swap payments received in advance

13. Income, like profits and gains, is a concept of the world of affairs, particularly business (*Commissioner of Taxes (SA) v. Executor Trustee and Agency Co. of South Australia Ltd* (1938) 63 CLR 108 at 152 (*Carden's case*)). The assessment of income involves discovering what gains have 'come home' to the taxpayer during the income year in a realized or immediately realizable form (*Carden's case* at 155). Gains, that is to say gross income, have 'come home' to the taxpayer when they are completely made and there is, therefore, neither legal nor business unsoundness in regarding them as income derived (*Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314 at 318).

14. A swap payment made in advance by a party is made in lieu of a series of periodic payments and calculated by reference to the net present value of those periodic payments. From the counterparty's

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perspective, the net present value sum is calculated to give, on receipt, a true reflex of its income in the circumstance of a swap transaction. As a matter of practical business understanding the advance payment is derived as income by the counterparty on receipt. For unlike the receipt of fees in *Arthur Murray*, the practical possibility of repayment is not an inherent characteristic of the receipt of a swap payment.

15. *Arthur Murray* concerned the receipt of fees for, and in advance of, the provision of dancing lessons. As discussed in Taxation Ruling TR 1999/11, the issue in *Arthur Murray* was whether, in the taxpayer's circumstances, receipt without earning made income. In determining this issue the High Court found that the characteristic of uncertainty was pivotal.

16. In *Arthur Murray* the uncertainty of retaining the advance fees, should the dancing lessons for which they were paid not be given, was the basis for the finding that the fees were not income when they were received. The practical possibility of repaying the fees in the event of the *quid pro quo* of dancing lessons not being rendered, prevented the receipt from having the quality of income. In other words, earning the fees by providing the dancing lessons overcame the inherent characteristic of the practical possibility of repayment and made the fees income.

17. However, there is no similar characteristic inherent in the receipt of an advance swap payment. In no practical sense is the recipient's retention of the advance payment compromised by their failure to make swap payments in return. Default under a swap agreement, in particular a swap covered by the ISDA Master Agreement of 1992, is remedied by damages designed to preserve the parties' benefits from the swap and determined principally by market conditions.

18. Upon entering into a swap, the parties elect to have their damages computed on the basis of either the loss suffered or the cost of the non-defaulting party entering into a replacement transaction. On either basis, however, the damages are calculated by reference to market conditions prevailing at the time of default. Those conditions may be such that the defaulting party could incur no liability for damages and could be paid damages by the non-defaulting party.

19. Damages cannot, therefore, represent the repayment of an advance swap payment in any legal, economic or practical sense. In these circumstances there is no uncertainty attaching to the retention of an advance swap payment. On the contrary, it is a gain completely made on receipt and there is neither legal nor business unsoundness in regarding it as income derived.

Detailed contents list

20. Below is a detailed contents list for this draft Ruling:

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Your comments

21. We invite you to comment on this draft Taxation Ruling. We are allowing 6 weeks for comments before we finalise the Ruling. If you want your comments to be considered, please provide them to us within this period.

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|--------------------------|---|
| Comments by Date: | 17 November 1999 |
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Commissioner of Taxation

13 October 1999

Previous draft:

Not previously issued in draft form

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Related Rulings/Determinations:

IT 2050; IT 2682

- ITAA36 82KZL
- ITAA36 82KZM
- ITAA97 6-5
- ITAA97 8-1

Subject references:

- advance expenses and payments
- assessable income
- deductions and expenses
- swaps

Case references:

- Commissioner of Taxes (SA) v. Executor Trustee and Agency Co of South Australia Ltd (1938) 63 CLR 109
- Arthur Murray (NSW) Pty Ltd v. FC of T (1965) 114 CLR 315

Legislative references:

- ITAA36 25(1)
- ITAA36 51
- ITAA36 51(1)

ATO references:

NO 99/14048-8

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ISSN: 1039 - 0731