TR 94/D27 - Income tax: section 51AD - deductions not allowable if non-recourse finance of asset used by tax exempt or other entity

This document has been finalised by TR 96/22.

Draft Taxation Ruling

Income tax: section 51AD - deductions not allowable if non-recourse finance of asset used by tax exempt or other entity

other Rulings on this topic

IT 2602; IT 2632

contents para

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 which 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 discusses the application and interpretation of section 51AD. It provides a general overview of the provision, restates the positions outlined in previously issued Taxation Determinations on the section, and discusses several further examples of the application of the section. In particular, it deals with the following questions:

(a) the requirements of the section;

(b) whether the finance will be non-recourse if there are guarantees, put or call options or the release of securities;

(c) examples of indirect finance;

(d) the meaning of "predominant";

(e) whether the discretion would be exercised where property is leased to a tax exempt body on commercial terms that would be available to non-exempt lessees, or where the lease is a genuine operating lease;

(f) whether the discretion would be exercised if the assets of other companies in the group are put at risk;

(g) whether, when section 51AD applies, it operates to reciprocally deny the derivation of relevant assessable income of a taxpayer.

2. This Ruling does not cover in detail 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.

Ruling

Overview of section

3. In summary, section 51AD will operate to deny depreciation and other deductions to the owner of property if:

- a tax-exempt entity such as a government, or another relevant entity, is leasing the property, has a right to use the asset, or has effective control of the property, and
- the whole or a predominant part of the purchase price or construction cost of the property was financed by non-recourse debt.

4. Broadly, a non-recourse debt is one where the lender's rights against the taxpayer in the case of default in repayment are effectively limited to rights against or in relation to the property, or against income generated or goods produced by the property. That is, the lender would not have the usual rights of access to the general assets of the taxpayer in an action for recovery of the debt. Certain other arrangements that would have the effect of similarly limiting the real risk of the borrower may also cause a debt to be treated as a non-recourse debt.

Use or control by exempt or other entity

5. Subsection 51AD(4) sets out the first requirements of the section. Broadly, the provision will apply if a person holds rights as lessee or controls, will control, or is or will be able to control, directly or

indirectly, the use of the property, and that person (the end-user) is either

- not a resident of Australia and the property is, or is to be, used wholly or principally outside Australia, or
- the property is, or is to be, used otherwise than wholly and exclusively for the purpose of producing assessable income, or
- the property was, prior to its acquisition by the taxpayer, owned, and used or held for use, by the end-user.

Use otherwise than to produce assessable income

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

7. Control means "effectively control" (subsection 51AD(1)). Taxation Ruling IT 2602, which deals with "Privately Owned Power Stations Controlled by State Electricity Authorities", discusses the control test in section 51AD in more detail.

Need not be exclusive use

8. A tax-exempt entity can control the use of property even though the property is also used by another entity and the tax-exempt entity does not have the actual physical use of the property.

9. The case of *Transfield Kumagai Contracting Pty Ltd v. Federal Commissioner of Taxation* 90 ATC 4960 dealt with equipment installed in the Sydney Harbour tunnel. The tunnel was leased to the taxpayers for 30 years by the Roads and Traffic Authority (RTA). The tunnel would revert to the RTA at the end of the 30 year arrangement. Grove J. held that the RTA used and controlled the equipment. It was not essential that the RTA have exclusive use of the tunnel or that it have an immediate physical association with the objects. Grove

J. said that "to use in an ordinary sense is to utilise, to take advantage of or to exploit." (p. 4963)

Exempt if public authority

10. It is possible that an entity which controls or uses the asset may be tax-exempt by virtue of paragraph 23(d), which exempts the income of "a municipal corporation or other local governing body or of a public authority constituted under any Act or State Act, or under any law in force in a Territory being part of Australia".

11. Taxation Ruling IT 2632, which deals with the meaning of "public authority" in the definition of "exempt public body" in Division 16D, is also relevant when examining the potential application of section 51AD.

12. See example 1 (in paras 65 to 67).

Non-recourse debt

13. The second requirement of section 51AD is that the whole or a predominant part of the cost of the acquisition or construction of the property was financed directly or indirectly by non-recourse debt. This test is set out in subsection 51AD(8). Generally, this provision is satisfied either by a contractual limitation of the rights of the creditor against the assets of the taxpayer or by the practical limitation of the creditor's rights to those specifically listed in paragraph 51AD(8)(a). Such a practical limitation arises when the assets of the taxpayer are at least predominantly limited to those listed in paragraph 51AD(8)(a).

14. The debt will be non-recourse if, in the event of default in the repayment of principal or payment of interest on the debt used to acquire or construct the property, the rights of the creditor or creditors *as against the taxpayer* are limited wholly or predominantly to any or all of the following:

(i) rights (including the right to moneys payable) in relation to any or all of the following:

(A) the property or the use of the property;

(B) goods produced, supplied, carried, transmitted or delivered, or services provided, by means of the property;

(C) the loss or disposal of the whole or a part of the property or of the taxpayer's interest in the property;

(ii) rights in respect of a mortgage or other security over the property;

(iii) rights 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.

15. By virtue of paragraph 51AD(8)(b) a debt will also be treated as a non-recourse debt if the rights of the creditor or creditors as against the taxpayer in the event of default "are in the opinion of the Commissioner capable of being so limited [that is limited to the same rights listed in (a)], having regard to either or both of the following:

(i) the assets of the taxpayer;

(ii) any arrangement to which the taxpayer is a party".

16. Thus for example, if the only asset of the taxpayer was the property, or a right to receive lease income from that property, the debt would still be a non-recourse debt even if there was no contractual or formal limitation of the rights of the creditor as against the taxpayer.

17. This situation most frequently arises if the taxpayer is a special purpose vehicle with no other assets. Even if the taxpayer is not a special purpose vehicle, it will be necessary to look at the net assets, that is taking account of any liabilities, actually held by that taxpayer.

18. Assets held by companies or trusts owned or controlled by the taxpayer are not themselves assets "of the taxpayer" and cannot be taken into account for the purposes of this test.

Assurances and guarantees

19. 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. 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 additional rights to those specified in paragraph 51AD(8)(a) as being non-recourse. If only the creditor has a right to sue the third party, the assurance or guarantee will not give the creditor additional recourse against the taxpayer.

20. 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" a financial obligation "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.

21. Even if the right gives the creditor additional recourse, the debt may still be non-recourse if the right has a limited value. For example, if the terms of a guarantee, a deed of priority or some other arrangement provide that the right of the taxpayer to recover from the guarantor or surety is only to be exercised after all other rights have been exercised, the rights of the creditor as against the taxpayer may still be or be capable of being limited wholly or predominantly to assets listed in paragraph 51AD(8)(a). Any rights against the taxpayer provided by the assurance or guarantee will provide no greater additional recourse than the available net assets of the surety or guarantor.

22. See examples 2 and 3 (in paras 68-71 & 72-80).

Put or call options

23. 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). [See TD94/4]

24. Where a put or call option for the assets market value at the time of exercise exists over other assets, this does not increase the net assets of the taxpayer.

Example

25. A taxpayer X Co, incorporates a special purpose subsidiary company Y Co, 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, Y Co 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.

26. Y Co then enters into an arrangement with a third party non associate of either X Co or Y Co, Z Co. Under that arrangement, Y Co is entitled to put the property to Z Co at the time an event of default by Y Co occurs in meeting its loan obligations to Bank Co.

27. The rights of Bank Co as against the taxpayer Y Co are limited in terms of section 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.

28. 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 fallacious. The rights arising from the put option are merely rights in relation to the property, being rights arising from taxpayer's disposal of the property

Release of security by debtor

29. Taxation Determination TD 92/141 addressed the question of whether the rights of a creditor in the

following circumstances were limited in the manner specified in subsection 51AD(8), or were capable of being so limited?

Example

30. A taxpayer, X Co, with substantial assets finances the acquisition cost of plant predominantly with debt from Y Co. The property is leased to a tax exempt body for 10 years.

31. The debt principal is repayable in 10 years and is secured against all the assets of X Co. Under the arrangement between X Co and Y Co, Y Co 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.

32. In the circumstances outlined in the Example, the rights of Y Co as against X Co 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.

Indirect finance

33. Taxation Determination TD 92/138 provided examples of circumstances in a company group structure where the acquisition of property is regarded as being indirectly financed by non-recourse debt.

34. Subsection 51AD(8) specifies that section 51AD does not apply unless the whole or a predominant part of the cost of acquisition or construction of the property is financed directly or indirectly by non-recourse debt.

35. The following is an example where, in a company group structure, the acquisition of property is considered to be financed indirectly by non-recourse debt:

(a) X Co, a company with substantial assets, borrows money on a non-recourse basis and then applies the borrowed funds to capitalise a wholly owned subsidiary company, Y Co.

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

36. In Y Co's hands the cost of acquisition of the property is financed indirectly through non-recourse debt, and accordingly section 51AD applies.

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

(a) X Co, a company with substantial assets, borrows on a full-recourse basis and then on-lends those funds to a wholly owned subsidiary company, Y Co.

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

38. In terms of paragraph 51AD(8)(b), the intermediate intra group loan technically is a non-recourse debt because Y Co is a special purpose company with no assets other than the property. Because the company group comprising X Co and Y Co is at risk for all of its substantial assets, the discretion in subsection 51AD(9) would be exercised to treat the rights of the creditor as not being, or capable of being, so limited.

39. Accordingly, subsection 51AD may not apply to this arrangement.

Wholly or predominantly

40. As previously outlined in Taxation Determination TD 92/137, the view is taken that the section does not apply unless more than 50% of the cost of acquisition or construction of the relevant property has been financed by non-recourse debt.

41. The word 'predominant' is not defined in income tax law. Therefore it bears its common meaning. The Macquarie Dictionary defines 'predominant' as:

(a) having ascendancy, power, authority, or influence or influence over others; ascendant.

(b) prevailing.'

Debt

42. In applying the dictionary definition to determine whether a predominant part of the cost of acquisition or construction of property has been financed by non-recourse debt, the closest meaning would be 'having ascendancy' i.e. more or greater than other costs. While technically that could be a percentage less than 50%, we take the view that, in the context of section 51AD, the section does not apply unless more than 50% of the cost of acquisition or construction of the relevant property has been financed by non-recourse debt as defined in subsection 51AD(8).

Recourse

43. The phrase "wholly or predominantly" is also used in determining whether the rights of the creditor or creditors as against the taxpayer in an event of default in the repayment of principal or repayment of interest are limited or are capable of being limited wholly or predominantly to rights in relation to the property as listed in paragraph 51AD(8)(a).

44. In the event of the worst possible default by the taxpayer in the repayment of principal and interest, the creditor must have the right to recover more than half the amount of principal and interest outstanding from the taxpayer by access to rights against the taxpayer that are not rights in relation to the financed property as listed in paragraph 51AD(8)(a), or else the creditor's rights will be capable of being limited.

45. Whether the creditor has rights which are capable of being limited will not be evaluated on the basis of the gross value of the other rights to which the creditor has access. Other liabilities ranking with or ahead of liability to the creditor must be taken into account. So must restrictions on the exercise of particular rights.

46. For instance, a taxpayer might have assets other than rights in relation to the financed property, and those assets might be able to satisfy far more than half the taxpayer's worst possible default to the creditor. Yet the creditor's rights in relation to those assets may be limited to "last recourse" rights, after exercise of all possible rights in relation to the financed property. In such a case, the creditor's rights are, or are capable of

being, predominantly limited to the rights in relation to the financed property. As a matter of commercial practice, creditors rarely provide finance greater than a conservative estimate of the minimum value of the financed property.

47. Similarly, the value of any rights against the taxpayer other than rights in relation to the financed property is reduced by any other liabilities which are not subordinated to the claims of the creditor. Such liabilities have an equal or higher claim on the rights than the claims of the creditor. For example, an asset subject to a charge or security for another liability has only its residual value to a creditor. A creditor whose claim to particular assets would rank equally with other claims has no more rights than those represented by a proportionate share of the assets. In effect, only the net assets available to a creditor are relevant.

48. Some assets of a taxpayer produce corresponding liabilities of the taxpayer. For instance, a loan to the taxpayer implies an obligation to repay the loan. Nevertheless, the rights of a creditor may be increased, if the creditor has rights in relation to the asset - say, money lent - with priority over the corresponding liability - say, the lender's right to repayment.
A practical example of this is uncalled capital in a taxpayer; the rights of the shareholders are generally subordinated to those of a creditor, and so uncalled capital may represent an additional asset of the taxpayer available to the creditor, subject to other liabilities but not reduced by the subordinated liability to repay shareholders. Of course, the value of the right to call uncalled capital is limited by the capacity of the shareholders to pay the call.

Example

49. A partnership of individuals acquired a building which was leased to a tax-exempt government entity. 80% of the cost of the building was financed by loans taken out by the partnership. The taxpayers were advised that section 51AD would apply unless the individuals had sufficient net assets other than assets listed in subsection 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 regard

would only be had to assets held directly by the taxpayer, not to assets held by associated companies or trusts, as these are separate taxpayers.

50. It was not accepted that intangibles such as goodwill and the professional status and standing of the individuals, the capitalised value of a stream of income or the equity the individuals had in the property were other assets for section 51AD purposes. In addition, even though it was unlikely that the individuals involved would fail to pay any amounts owing by them, because of their professional status, it was not accepted that this factor would prevent section 51AD applying. Section 51AD looks to the rights of the creditors against the taxpayer, not the likelihood that the creditors will be paid.

The discretion

51. 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."

52. 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

.

Commercial lease

53. Taxation Determination TD 92/139 addressed the question of whether the discretion would be exercised where property is leased to a tax exempt body on commercial terms that would be available to non-exempt lessees, or where the lease is a genuine operating lease.

54. The discretion under 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.

55. Against that background, the discretion would not be exercised simply because of the commerciality of the lease or its categorisation as an operating lease.

Group assets at risk

56. Taxation Determination TD94/1 addressed the question of whether the discretion would be exercised if the assets of other companies in the group are put at risk.

57. A company which borrows to finance the acquisition or construction of a property may satisfy the tests in subsection 51AD(8) if it has few assets. In such cases the parent or another group company, as defined in section 80G, may put assets at risk to support the borrowing.

58. If the assets of another group company are put at risk, then consideration would be given to the exercise of the discretion in subsection 51AD(9). What constitutes sufficient assets and adequate exposure to risk can only be determined on the facts of each particular case.

If section 51AD applies

Deductions not allowable

59. 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.

Does not deny derivation of income

60. TD94/3 addressed the question of whether, where the section applies, it operates to reciprocally deny the derivation of relevant assessable income of a taxpayer.

61. The answer is no. 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.'

62. 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 would 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

63. 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

64. The rationale behind section 51AD was set out in the Press Release of the then Treasurer, John Howard M.P., No. 229 of 18 December 1981:

> "The Government has reviewed the implications of the recent substantial growth in the use of leveraged leasing and similar arrangements. In the case of some of these arrangements, the benefits to the lessee and to the lessor involve a significant cost to Commonwealth revenue.
>
> It has noted in particular the increasing involvement of some non-taxable statutory

authorities in financing arrangements of this type for the purpose of expenditure on capital equipment at lower costs to themselves but, inevitably, at the expense of the general body of taxpayers.

The taxation advantage of a leveraged leasing or similar arrangement is to be found in the fact that the company which leases out the relevant plant and equipment is able to claim the investment allowance (where relevant) and the depreciation deduction against its taxable income more readily than the user of the equipment might have found possible. It can pass all or some of that benefit on to the user through lower rentals or other charges. Such arrangements can have a particular attraction for tax exempt bodies which may not otherwise be able to take advantage of either the investment allowance or depreciation deduction.

With respect to the investment allowance the intent of policy written into the present law is that the allowance should apply only to plant from which the "end user" derives assessable income. The Government has now decided to take immediate action to preserve that policy.

With effect from 19 December 1981, ...the investment allowance will no longer apply where a tax exempt statutory authority is the real "end user" of the plant. In other words, the allowance will be denied where the subject plant is used to provide goods or services to an organisation or authority (directly or through interposed parties) for use in relation to activities of the organisation or authority that are not subject to income tax and where the terms of the arrangements are such that effective control of the plant operations rests with the exempt organisation or authority, whether absolutely or through an agency that the exempt body controls."

Examples

Example 1

65.
- An infrastructure asset is leased by an Australian partnership for 10 years with an option to purchase.
- The financier partner, who holds a 99% interest in the partnership, puts equity equal to 20% of the cost of the asset into the partnership.
- The partnership borrows 80% of the cost of the asset. Half of the loan funds come from a State government financing entity. The loans are non-recourse.
- The asset will be managed by a corporatised entity, previously a branch of a State government, which is wholly owned by the State government, in the main financed by the State government, and fully backed by the State government.
- The relevant Auditor-General may be appointed and act as the auditor of the Company. The relevant Minister must present the Company's financial statements, director's and auditor's reports to the Parliament. Two Departmental Secretaries will be on the Board of Directors. The shareholders can impose limits on the amount that the Company may borrow from persons other than the Treasurer, in order to ensure compliance with Loan Council limits.
- The corporatised entity guarantees that the Australian partnership will receive adequate funds to meet 84% of its debt obligations and to ensure a minimum rate of return. The State Government guarantees that it will provide any funds necessary for the corporatised entity to meet these guarantees.
- The corporatised entity will receive an annual management fee for managing the asset. Any excess profits will remain in the corporatised entity.

- The State government will receive guarantee fees from the offshore partnership and the Australian partnership equal to 13% of the cost of the asset.
- The asset is leased from an offshore partnership which also claims capital allowances on the asset.
- The Australian partnership pays another company (X) 100% of the cost of the asset in consideration for it making the lease and option payments on its behalf (a defeasance).
- X makes a loan of 100% of the cost of the asset to the offshore partnership.
- The offshore partnership purchases the asset.
- X pays the lease and option payments to the offshore partnership as they accrue.
- The offshore partnership makes loan repayments to X as they accrue.

66. Section 51AD will apply to this arrangement. The corporatised entity which manages the asset is a public authority for the purposes of paragraph 23(d) and hence exempt from tax. Accordingly, the use of the asset is controlled by a tax exempt entity.

67. An argument that the acquisition of the asset was not financed by non-recourse debt because the guarantees represented substantial other assets of the taxpayer was not accepted. The guarantees are rights arising out of an arrangement relating to the financial obligations of the end-user of the property (the corporatised entity) towards the taxpayer (the Australian partnership), 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

68. • A has owned an asset for almost 10 years and leased it to another company in the same group, A2.

- A is to sell the asset for $50m to a unit trust subject to a lease of the asset to A's parent company, A3. The unit holders in the trust are $2 companies.
- The asset will be leased for a long term.
- The trust will finance 100% of the cost of acquisition of the property with a loan repayable over the same term as the lease.
- A3 will issue promissory notes payable to the trust endorsed by another group company, A4. The face value of the promissory notes is commensurate with the rental payable by A3 under the lease. The notes mature and become payable progressively over the term of the lease. As payment is made to the trustee of the trust on maturity of each promissory note, the moneys will be received in full satisfaction of the tenant's obligation for payment of rentals under the lease.
- The A group will have a first right of refusal to buy the property at the prevailing market value should the trust wish to sell the property in the future.

69. The first limb of section 51AD would be satisfied as the property was, prior to its acquisition by the trust, owned and used by associates of A3 (the end-user). (See subsections 51AD(4)(a)(iii) and 51AD(5).)

70. It was argued that the promissory notes were substantial assets of the trust which prevented subsection 51AD(8) being satisfied. This argument was not accepted, as it was considered that the rights arising from the promissory notes were rights 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, namely the obligation to pay the rent. The promissory notes were issued by the lessee.

71. Section 51AD would apply to the arrangement. The discretion would not be exercised.

Example 3

72. B is to acquire assets using finance provided by a bank and lease those assets to another entity, F.

73. One-third of the shares in B are held by another unrelated company, C, one third by D and one-third by E. D holds 51% of the shares in F.

74. D has entered into an undertaking to pay with B under which D unconditionally and irrevocably agrees to pay B on demand any and all amounts which are at any time due to the bank which B fails or determines it is unable, for any reason, to pay the bank from time to time.

75. Apart from a comparatively small amount of paid up capital, B's other assets are the leased assets themselves, rights arising from the lease of the assets and other rights related to the assets.

76. It was assumed that the undertaking to pay would be enforceable by B, and that neither a proposed Deed of Priority nor any other agreement provided that D's undertaking to pay would only be called upon after any, or after all, other rights were exhausted.

77. It was also assumed that D would hold directly sufficient net assets, and would at all times hold sufficient net assets accessible to the creditor to provide at least 50% of the principal due to the bank at that time, plus at least 50% of any interest due at that time.

78. Assets not held directly by D would not be taken into account in deciding this question. In determining the net assets of D for these purposes, the assets held by F were not to 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 the basis of these assumptions, it was accepted that the debt provided by the bank, to finance the acquisition of the leased assets by B did not constitute non-recourse debt for the purposes of subsection 51AD(8).

80. 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 B.

Example 4

81. A acquires land and constructs an office building to be tenanted by a government entity. A borrows 80% of the cost of construction through a loan from the builder. It is a condition of this first loan that upon completion a second loan be in place so that the first may be paid out. The second loan is made on condition that the principal outstanding at the end of the term of the second loan be paid out by either a third loan or by exercise of an option for the disposal of the property to that third financier.

82. In these circumstances, all three loans are considered to be for the cost of construction or acquisition of the building. At the time of the buildings construction A was required to utilise three financiers to finance the construction. The first loan would not have been provided but for the second being in place, and the second was dependent on the third. A needed the three loans to finance the cost of construction and the loans were interdependent.

Commissioner of Taxation

9 June 1994

ISSN 1039 - 0731

ATO references
NO 94/748-2
BO

Not previously released to the public in draft form

Price $2.00

FOI index detail
reference number

subject references
- exempt lessee
- leases
- non-recourse finance
- use or control
- wholly or predominantly

legislative references
- ITAA 51AD

case references
- Transfield Kumagai Contracting Pty Ltd v. F.C. of T. 90 ATC 4960;