

Tax Brief

15 May 2009

In-house Finance Companies

It is no secret that the Australian Taxation Office (“**ATO**”) has been concerned for some time about the tax issues arising from in-house finance companies operating within large listed groups. A recent decision of the Federal Court involving an in-house finance company in the BHP Billiton group has, at least for the moment, stalled the ATO’s efforts to insist on its view of the way the tax issues should be addressed. It also offers the first judicial guidance on the operation of the relatively recent limited recourse debt rules.

1. Background

The ATO’s concerns about the role and tax effects of in-house finance companies have been outlined in a number of public speeches given by ATO officials. The concerns hinted at in the speeches revolve around a number of separate themes – the potential to use in-house finance companies to convert capital losses into deductible revenue losses, the potential to duplicate the same economic loss in several places and the potential to claim deductions for outgoings that will never be met. The ATO also appeared concerned that, on the other side of the transaction, some groups were claiming that the debt forgiveness rules and the limited recourse debt regime were not enlivened so that the tax impact of the lender’s write-off was not mitigated to some extent by adjustments to the tax position of the borrowing entity. The ATO’s thoughts about how to attack perceived abuses, foreshadowed in the speeches, focussed on denying that in-house finance companies were carrying on a business of money-lending, perhaps because the transactions were too few, were entirely internal to the group, were not monitored in a sound manner or were made to borrowers that were not creditworthy.

These speeches were not unexpected. It had been reported in the press as long ago as 2005 that the ATO was examining the position of a number of groups including BHP-Billiton and the Fosters group (in respect of events occurring from the days when it was Elders-IXL). Similarly, in one of the first public rulings on the consolidation system, the ATO had fired a warning shot, announcing that “intra-group money lending transactions or dealings are not taken into account in determining whether the head company of a consolidated group is carrying on business as a money lender for income tax purposes.”

The first of the disputes recently started reaching the Courts. In 2008, two cases in the Federal Court had involved procedural skirmishes in the Fosters dispute. The decision in the BHP Billiton case handed down last month squarely addresses the substantive issue – whether an in-house finance company is entitled to a deduction for the loss crystallised on writing off as a bad debt the principal and accrued but unpaid interest on loans made to other entities in the same corporate group.

2. Facts

The case arose out of the decision in 2000 by BHP Billiton Finance Ltd (“**Finance**”) to write off the principal – totalling about \$2bn – of two loans made to other BHP subsidiaries. The taxpayer claimed a tax deduction for amount written off as a bad debt on the basis that it was carrying on business as a money lender. As a result of this, the two borrowers made adjustments to their tax positions on the basis that the commercial debt forgiveness rules applied to them.

The Commissioner disputed the deduction claimed by Finance on a series of grounds: that Finance was not carrying on an independent business as a money lender, that the loans were not made in the ordinary course of that business, that the loans were not bad when written off and that the general anti-avoidance rule applied to deny Finance the benefit of the tax deductions.

3. The bad debt deductions

A large part of the judgment – and it runs to more than 80 pages – is taken up with describing the facts and circumstances surrounding Finance’s operations: the frequency of its borrowings, the identity of the lenders, the amounts involved, the frequency and size of the loans it made to group members, the rates of interest charged and received, the terms of those loans, the loan documentation, the oversight of its loan portfolio, the circumstances surrounding the making of the 2 loans in question, the significance of letters of comfort given to the borrowers in connection with the borrowings, the possible revocation of those letters, the failure of the projects undertaken by the two borrowers, the decision to write off the 2 loans, and so on. This long recitation is not surprising since, at the heart of the case, lay questions of fact – was Finance carrying on a business as a money lender, were these loans within the ordinary course of that business and were they bad when written off?

The judge held that the extent of the borrowing and lending activities undertaken by Finance amounted to a business of money-lending, but the ATO’s line of attack on this ground was more nuanced – it was directed to the implications of the fact that Finance was a subsidiary member of a large corporate group. The Commissioner argued that Finance was not carrying on a money lending business because its activities were wholly controlled by BHP Billiton and it did not operate as an independent entity. The judge

rejected this argument on the facts and because it was contrary to long-established authority that a subsidiary is not a mere proxy for its parent.

The ATO also argued that the loans were not made in the ordinary course of that business. Again, this argument was rejected on the facts.

The ATO disputed that one of the loans was bad when written off. This argument stemmed from the fact that the borrowers had the benefit of letters of comfort from the parent company at the time that Finance made the loans, although there was some dispute about whether the letters remained on foot at the time that the loans were written off. The judge agreed with Finance that those letters created no rights in favour of Finance, and noted further that even if they did, their effect did not extend to support the ATO's argument – ie, the ATO could not claim the loans were still viable simply by showing that Finance might have been able to bring some action based on the letters. The judge also rejected what she saw as the implication of the ATO's argument about the letters of comfort: that Finance could not view the debts as bad without going through some process to test their existence and effectiveness in favour of Finance. The ATO's argument does not sit easily with its Ruling on bad debts which says that, "it is not essential that a creditor take all legally available steps to recover the debt. What is necessary is that the creditor make a bona fide assessment, based on sound commercial considerations, of the extent to which the debt is bad."

The ATO advanced another argument that the debts were not "bad" based on the status of both parties as members of the BHP Billiton group. The ATO had apparently put the view that the debt should not be regarded as bad because, within a single corporate group, the parent could always put the borrower in funds to pay its debts. The judge re-stated the argument as amounting to a view that, "no debt between two wholly owned subsidiaries is ever bad because ... the parent will always 'sort it out'." She rejected the argument saying, "if such a submission were to be accepted, the effect would be that the form of all transactions between wholly-owned subsidiaries would be disregarded for tax purposes."

The ATO won on one point in the case which may be of ongoing interest for revolving loan facilities. Finance had argued, as an alternative, that it was entitled to a deduction for a lesser amount – the amount it had reported as accrued interest income over many years, and then written off. The argument was that these amounts were deductible under a separate provision which did not depend upon finding that Finance was carrying on business as a money-lender. The judge noted that under Finance's standard loan agreement, funds were advanced for a term of 5 months. At the end of each loan, the entire amount unpaid – the unpaid principal and accrued but unpaid interest – was rolled over into a new 5-month loan for the larger amount. According to the judge, the effect of the rollover was that the original debt was repaid in full with the borrowed funds and a new loan struck. When the total debt was eventually written off, it no longer represented the original amount advanced and a large amount of unpaid

interest; it represented the principal of the latest loan. This part of the judgment may be relevant for bill facilities and similar arrangements.

4. The general anti-avoidance rule

The ATO also issued a determination under the general anti-avoidance rule by which it purported to cancel the benefit of the deduction for the bad debts. Finance lost an argument that the making of the determinations was defective but it won the argument that the general anti-avoidance rule applied to deny the deductions.

The essence of the ATO position was that the letters of comfort operated to make the loans recoverable, so that when “good” loans were written off as bad, Finance was engaging in tax avoidance. The judge held against the ATO on the basis that any alternative course of action which might have been taken – rather than write off the debts – faced sufficient legal, commercial and practical difficulties that it was not reasonable to expect that the course of action would have been taken. And, in any event, the debts were bad when they were written off, not “good” as the ATO had argued.

5. The limited recourse debt issue

The case involved a subsidiary issue which also arose out of the decision to write off the debt.

The ATO argued that the loan to one of the subsidiaries was a limited recourse debt for the purposes of the tax legislation and had been used to construct or acquire various items of property. As a consequence, when the debt was written off by the lender, the limited recourse debt regime was enlivened and affected the tax position of the borrower. When these rules apply, the borrower can be required to reverse the effect of tax deductions it has previously claimed for various capital allowances such as depreciation and building allowance. The borrower had not made these adjustments, asserting that the loans written off were not limited recourse debt.

This part of the judgment turned largely on whether the debt was “limited recourse debt” for tax law purposes (there was another issue about which property had been financed with debt and which with other funds). The definition of limited recourse debt in the legislation contains two alternatives:

- the first test asks whether the creditor’s rights are limited “wholly or predominantly” to rights against a particular item of property, the product of that property and so on; and
- the alternative test is whether it is reasonable to conclude that the creditor’s rights are capable of being limited in this way.

Rights were in fact limited. Finance’s standard loan documentation contained no explicit limitations in the event of default. However, the ATO argued, first, that Finance’s rights were effectively limited in the way that the legislation envisaged – ie, the only rights Finance had as an unsecured

creditor were rights that could only be enforced against various items of property.

The judge disagreed with this interpretation on a number of grounds:

- first, she disagreed with the ATO's view of the circumstances when rights were appropriately limited – if the ATO's view was correct, then every unsecured loan could become limited recourse debt if a project failed, even though the debt was full recourse when made; and
- secondly, she considered that the facts indicated that the company had many additional assets which could have been available to an unsecured creditor; Finance had rights to many assets, not just a few.

Rights were capable of being limited. The ATO also argued that it was reasonable to conclude that the creditor's rights were capable of being limited and so the debt was limited recourse debt under the second part of the definition. The ATO argued that this part of the definition should be understood as being satisfied if there were insufficient other assets available in the hands of the borrower – ie, the lender's rights were "capable" of being limited just to rights against the financed property if these were the main assets that were available to satisfy creditors.

Again, the judge disagreed. She said the provision was not intended to apply if the borrower was personally at risk in respect of the borrowed funds.

Financed with debt. However, the judge did support the ATO in its view that the acquisition or construction of the relevant assets – the assets in respect of which the borrower had been claiming capital allowances – was probably financed with debt. The main issue here was that the borrower had not attempted to isolate the assets acquired with equity and those acquired with debt. In the absence of such a tracing, the borrowers could not discharge the onus of proving which funds were used for which assets.

5. What next

The judge alluded to the likelihood that her decision would be appealed and the ATO has not proved her wrong – the ATO has lodged an appeal with the Full Federal Court and so this case may well have some distance to run.

Moreover, there are reasons for other taxpayers to be somewhat cautious about the implications of this decision. It is important to note that Finance was a very substantial and sophisticated operation. It had been in existence for 25 years and over that time had borrowed significant amounts – it had approval to borrow amounts exceeding \$2bn per annum – and consequently lent significant amounts to many companies within the group. During the period in question, it routinely had billions of dollars in debt on foot denominated in various currencies. It also entered into currency and interest rate swaps to manage the various exposures, and the documentation of its loans was sophisticated. This operation was of quite a different order to an in-house finance company or trust with a few borrowings and a handful of loans.

Secondly, some of the significance of the underlying issue has been removed by the consolidation regime. Writing off the bad debts of in-house finance companies operating within a consolidated group will not give rise to deductions. However, if either party to the loan is outside the consolidated group – say, a group lends outside the consolidated group to a joint venture subsidiary, or a stapled trust lends to a corporate group – then the issues in this case remain alive.

For further information, please contact

Sydney

Richard Hendriks

richard.hendriks@gf.com.au

phone 61 2 9225 5971

Andrew White

andrew.white@gf.com.au

phone 61 2 9225 5984

Melbourne

Adrian O'Shannessy

adrian.o'shannessy@gf.com.au

phone 61 3 9288 1723

Richard Shaddick

richard.shaddick@gf.com.au

phone 61 3 9288 1412

These notes are in summary form designed to alert clients to tax developments of general interest. They are not comprehensive, they are not offered as advice and should not be used to formulate business or other fiscal decisions.

Greenwoods & Freehills Pty Limited

ABN 60 003 146 852

Level 39 MLC Centre Martin Place Sydney NSW 2000 Australia

Facsimile (02) 9221 6516 Telephone (02) 9225 5955

Liability limited by a scheme approved under Professional Standards Legislation