

CR 2022/42 - Australian Government Bond holders - exchange of bonds for CHESS Depository Interests



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Status: **legally binding**

Class Ruling

Australian Government Bond holders – exchange of bonds for CHESS Depository Interests

❶ Relying on this Ruling

This publication (excluding appendix) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

If this Ruling applies to you, and you correctly rely on it, we will apply the law to you in the way set out in this Ruling. That is, you will not pay any more tax or penalties or interest in respect of the matters covered by this Ruling.

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What this Ruling is about

1. This Ruling sets out the income tax consequences for entities that elect to exchange an existing direct or beneficial holding of a Treasury Bond (TB) or a Treasury Indexed Bond (TIB) (collectively referred to in this Ruling as bonds) for a CHESS Depository Interest (CDI) in that bond.
2. Relevant details of the scheme are set out in paragraphs 14 to 33 of this Ruling.
3. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997*, unless otherwise indicated.

Who this Ruling applies to

4. This Ruling applies to you if you:
 - are either a holder of a TB or a TIB and your name is directly entered in the inscribed stock ledger governed by the *Commonwealth Inscribed Stock Act 1911* (CIS Act) (a direct bondholder) or a beneficial holder of a bond which is deposited electronically in the Austraclear System and held by Austraclear Limited (Austraclear) as nominee for you (a beneficial bondholder)
 - elect to exchange your existing holding of a bond for a CDI in that bond recorded against a CHESS Holder Identification Number in your name, and

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- do not hold your bond as trading stock for income tax purposes.

When this Ruling applies

5. This Ruling applies to the income years ended 30 June 2023 to 30 June 2027. The Ruling will continue to apply after 30 June 2027 to the entities specified in paragraph 4 of this Ruling who entered into the scheme during the term of this Ruling.

Ruling

CGT events

6. CGT event A1 in section 104-10 and CGT event E1 in section 104-55 will not happen when a direct bondholder or a beneficial bondholder (collectively referred to in this Ruling as bondholders) chooses to exchange a bond for a CDI.
7. CGT event H2 in section 104-155 will happen when a bondholder chooses to exchange a bond for a CDI. However, a bondholder will not make a capital gain or a capital loss from CGT event H2 happening, as there will be no capital proceeds or incidental costs incurred, arising from the exchange process.

Traditional securities – application of sections 26BB and 70B of the ITAA 1936

8. The TBs issued at face value or at a premium are traditional securities, as defined in subsection 26BB(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) (for the purposes of section 26BB and section 70B of the ITAA 1936).
9. TIBs are not traditional securities within the meaning of subsection 26BB(1) of the ITAA 1936 (for the purposes of section 26BB and section 70B of the ITAA 1936).
10. The exchange of TBs that are traditional securities will not constitute a disposal or redemption under section 26BB or section 70B of the ITAA 1936.

Qualifying securities – application of Division 16E of Part III of the ITAA 1936

11. Where the bonds are qualifying securities as defined in subsection 159GP(1) of the ITAA 1936, there will be no transfer of those bonds as a result of the exchange. Therefore, the exchange will not give rise to assessable income or an allowable deduction under section 159GP of the ITAA 1936.

Taxation of financial arrangements – application of Division 230

12. Where Division 230 applies to a bond, the exchange will not give rise to a balancing adjustment under section 230-435.

Application of sections 6-5 and 8-1

13. The exchange will not give rise to assessable income under section 6-5 or an allowable deduction under section 8-1.

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Scheme

14. The following description of the scheme is based on information provided by the applicant. If the scheme is not carried out as described, this Ruling cannot be relied upon.

Background

15. Section 4 of the CIS Act provides for the creation of stock, including TBs and TIBs, to enable the Australian Government to borrow money.

16. The Australian Office of Financial Management (AOFM) is responsible for the management and administration of bonds.

17. TBs carry a fixed annual rate of interest payable semi-annually and are redeemable at their face value on maturity. They may be issued for their face value, but are generally issued either at a premium or at a discount to their face value.

18. TIBs are issued with a face value of \$100 and their capital value is adjusted for movements in the Consumer Price Index. They are redeemable on maturity at their adjusted capital value. They carry a fixed annual rate of interest payable quarterly on the adjusted capital value.

19. Most of the bonds on issue are traded in the secondary market by phone or on electronic markets. These trades are settled via the Austraclear System operated by Austraclear, a wholly-owned subsidiary of ASX Limited. The Austraclear System is an electronic registry and settlement system for government, semi-government and private sector debt securities. Austraclear holds legal title in the inscribed stock ledger maintained under the CIS Act to all of the bonds held in the Austraclear System. Austraclear holds the bonds as nominee for the beneficial owners (the beneficial bondholders).

20. The remaining bonds issued under the CIS Act that are not held in the Austraclear System are held in the inscribed stock ledger. As at the date of this Ruling, there are approximately 110 (mainly retail) investors that hold bonds directly in the inscribed stock ledger (direct bondholders) and they account for less than 0.1% of the aggregate face value of all bonds on issue.

21. In 2013, the Australian Securities Exchange (ASX) and the AOFM established a facility to allow retail investors to trade in exchange-traded Australian Government Bonds. These are known as exchange-traded Treasury Bonds (eTBs) and exchange-traded Treasury Indexed Bonds (eTIBs). These bonds are not issued under the CIS Act. Instead, retail investors acquire beneficial interests in TBs and TIBs. Accordingly, the *Corporations Act 2001* was amended to facilitate trading of beneficial interests in TBs and TIBs on financial markets in Australia that are accessible to retail investors.

22. These beneficial interests are collectively known as 'CDIs in bonds'. Trading of CDIs in bonds commenced on the ASX on 21 May 2013.

23. CDIs settle through the Clearing House Electronic Sub-register System (CHES), the settlement system for financial products traded on the ASX, and are recorded on the Australian Government Bond Depository Interest Register.

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The proposed inscribed exchange facility and CHESS Depository Interests

24. The AOFM has established a voluntary exchange or 'transmutation' facility under which bondholders may choose to exchange an existing direct or beneficial holding of a bond for a CDI in that bond. This is intended to:

- allow direct bondholders a simpler method than is currently available by which they can hold, manage and sell their holdings
- enable beneficial bondholders to transfer an existing holding from the Austraclear System participant account to a CDI, and
- facilitate the AOFM to consolidate its registers.

25. The CDIs will be issued on a 1:1 exchange basis (that is, one CDI unit of \$100 face value will be issued for every \$100 face value of bonds held by a bondholder).

26. In the case of beneficial bondholders, the bond will first be withdrawn from the Austraclear System to the beneficial bondholder, with legal title transferred in the inscribed stock ledger.

27. The CDIs will be governed by the ASX Settlement Operating Rules. Pursuant to section 13 of those rules, legal title to the bonds currently held by direct or beneficial bondholders who choose to exchange them will then be transferred to the depository nominee, CHESS Depository Nominees Pty Limited (CDN).

28. CDN will then lodge the bond into the Austraclear System by transferring legal title to the bond to Austraclear.

29. A CDI will be created over the bond and the bondholder will be recorded as the holder of the CDI in a broker sponsored CHESS account established by the bondholder.

30. The CDIs will be listed and traded on the ASX and, when traded, the CDIs will settle electronically through CHESS.

31. The bonds will not be cancelled or redeemed.

32. The holder of a CDI will retain the beneficial ownership of the underlying bond and be entitled to all of the economic benefits (including coupon payments and principal repayments which will be made directly to the CDI holder) and be exposed to all of the risks attached to legal ownership of the bond. The Australian Government, through the AOFM, will continue to have the primary obligation for meeting the interest and principal payments due to holders of CDIs in bonds.

33. Bondholders will not be required to pay any fees, commissions or other amounts in respect of an exchange.

Commissioner of Taxation

11 May 2022

Status: **not legally binding**

Appendix – Explanation

❶ *This Explanation is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

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CGT events

34. A bond is a CGT asset (section 108-5).

35. CGT event A1 happens if a taxpayer disposes of a CGT asset and the disposal involves a change of ownership from the taxpayer to another entity (subsections 104-10(1) and 104-10(2)). However, a change of ownership does not occur if the taxpayer stops being the legal owner of the asset but continues to be its beneficial owner (subsection 104-10(2)).

36. CGT event E1 happens when a taxpayer creates a trust over a CGT asset by declaration or settlement (subsection 104-55(1)). However, subsection 104-55(5) provides that CGT event E1 does not happen if the taxpayer is the sole beneficiary of the trust and:

- is absolutely entitled to the asset as against the trustee (disregarding any legal disability), and
- the trust is not a unit trust.

37. A trust is an entity for income tax purposes (subsection 960-100(1)).

38. The trustee of a trust is taken to be an entity consisting of the person who is the trustee, or persons who are trustees, at any given time (subsection 960-100(2)). The mere appointment of a new trustee to a trust will not cause a disposal for income tax purposes.

39. CGT event H2 happens when an act, transaction or event occurs in relation to a CGT asset that a taxpayer owns and that act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base (section 104-155).

40. Under section 106-50, a CGT asset of a trust to which a beneficiary is absolutely entitled as against the trustee (disregarding any legal disability) is treated for CGT purposes as being the beneficiary's asset (rather than an asset of the trust). Furthermore, any act done in relation to the asset by the trustee is taken to be done by the absolutely entitled beneficiary (rather than the trustee).

41. The ASX has instituted a system of trading the bonds which involves a CDI as the instrument of ownership of a bond. The CDI is the means by which direct and beneficial bondholders will continue to enjoy the advantage of ownership of bonds, including the ability to sell them, following the exchange.

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42. In accordance with ASX requirements, where a direct bondholder holds a bond on the inscribed stock ledger, a trust is created over a bond to facilitate its transmutation to a CDI.

43. Where a beneficial bondholder holds a bond on the Austraclear System, a trust already exists over the bond. The transmutation to a CDI results in the mere change of trustee.

44. Only the CDI holder has the right to benefit from the bond or to deal with it (the CDI being the medium through which they do so).

45. Accordingly, the CDI holder will be absolutely entitled to the bond for the purposes of the CGT provisions.

46. Therefore, the exchange will not trigger a disposal to another entity as that term is defined in subsection 104-10(2) (meaning CGT event A1 will not happen), and the exception in subsection 104-55(5) will apply (meaning CGT event E1 will not happen).

47. The exchange will cause CGT event H2 to happen, being an act, transaction or event which occurs in relation to a bond and does not result in an adjustment being made to the bond's cost base or reduced cost base.

48. As a bondholder will receive no capital proceeds (defined in subsection 116-20(2) for the purposes of CGT event H2) from the exchange and will incur no incidental costs that relate to the exchange, a bondholder will not make a capital gain or capital loss from CGT event H2 happening as a result of the exchange.

Traditional securities – application of sections 26BB and 70B of the ITAA 1936

49. A 'traditional security' is defined in subsection 26BB(1) of the ITAA 1936 as a 'security' that:

- is or was acquired by the taxpayer after 10 May 1989
- does not have an eligible return or has an eligible return that meets certain conditions
- is not a prescribed security within the meaning of former section 26C of the ITAA 1936¹, and
- is not trading stock.

50. A bond which is a TB issued at face value or at a premium is a traditional security, as it satisfies paragraph (a) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936, and does not have an 'eligible return' as defined in subsections 159GP(1) and 159GP(3) of the ITAA 1936.

51. A gain on the disposal or redemption of a traditional security will give rise to assessable income under subsection 26BB(2) of the ITAA 1936. A loss on the disposal or redemption of a traditional security will give rise to an allowable deduction under subsection 70B(2) of the ITAA 1936.

52. The exchange is merely the mechanism through which a CDI is issued to a bondholder in respect of the underlying bond to facilitate its subsequent realisation or disposal on the ASX.

¹ This requirement is only applicable to securities issued before 6 May 2016.

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53. The exchange will not constitute the redemption of the bond and, as it does not result in the sale, transfer or assignment of the bond, nor will it constitute a disposal of the bond for the purposes of sections 26BB and 70B of the ITAA 1936.

Qualifying securities – application of Division 16E of Part III of the ITAA 1936

54. Bonds which are TIBs, or TBs issued at a discount, are likely to have an eligible return (as defined in subsections 159GP(1) and 159GP(3) of the ITAA 1936) and therefore are likely to constitute a ‘qualifying security’ within the meaning of subsection 159GP(1) of the ITAA 1936.

55. Where the bonds are qualifying securities, the ‘transfer’ (as defined in subsection 159GP(1) of the ITAA 1936) of a qualifying security will give rise to assessable income under subparagraph 159GS(1)(a)(i) and paragraphs 159GS(1)(b) and 159GS(2)(b) of the ITAA 1936. The transfer of a qualifying security will give rise to an allowable deduction under subparagraph 159GS(1)(a)(ii) and paragraph 159GS(2)(a) of the ITAA 1936.

56. However, the exchange will not result in a transfer of the bond for the same reasons that it will not constitute the disposal or redemption of a traditional security for the purposes of sections 26BB and 70B of the ITAA 1936. Therefore, the exchange will not give rise to assessable income or an allowable deduction under section 159GS of the ITAA 1936.

Taxation of financial arrangements – application of Division 230

57. A bond is a ‘financial arrangement’ within the meaning of section 230-45.

58. To the extent that Division 230 is capable of applying to a bond, the exchange will give rise to a balancing adjustment under subsection 230-435(1) if:

- (a) the bondholder transfers to another entity all their rights and/or obligations under the bond
- (b) all of the bondholder’s rights and/or obligations under the bond otherwise cease
- (c) the bondholder transfers to another entity a proportionate share of their rights and/or obligations under the bond, or
- (d) the bond ceases to be a ‘Division 230 financial arrangement’.

59. The exchange of a bond will not give rise to a balancing adjustment under subsection 230-435(1) for the following reasons:

- the bonds are assets of the bondholders, who will not transfer ‘substantially all the risks and rewards of ownership of the interest’ in the bonds as a result of the exchange (subsection 230-435(3)), so that points (a) and (c) of paragraph 58 of this Ruling are not satisfied
- the bondholder will retain the right to coupon payments and principal repayment in respect of the bond, so that point (b) of paragraph 58 of this Ruling is not satisfied, and
- the bond does not cease to be a Division 230 financial arrangement as a result of the exchange, so that point (d) of paragraph 58 of this Ruling is not satisfied.

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Application of sections 6-5 and 8-1

60. To the extent that a bond is a 'revenue asset', the exchange will not constitute the realisation of a bond by the bondholder. Therefore, the exchange will not give rise to any profit which is included in assessable income under section 6-5 or a loss which is an allowable deduction under section 8-1.

Status: **not legally binding**

References

Related Rulings/Determinations:

CR 2014/55; CR 2018/4

Legislative references:

ITAA 1936 26BB

ITAA 1936 26BB(1)

ITAA 1936 26BB(2)

ITAA 1936 26C

ITAA 1936 70B

ITAA 1936 70B(2)

ITAA 1936 Pt III Div 16E

ITAA 1936 159GP

ITAA 1936 159GP(1)

ITAA 1936 159GP(3)

ITAA 1936 159GS

ITAA 1936 159GS(1)(a)(i)

ITAA 1936 159GS(1)(a)(ii)

ITAA 1936 159GS(1)(b)

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ITAA 1997 104-55(1)

ITAA 1997 104-55(5)

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ITAA 1997 106-50

ITAA 1997 108-5

ITAA 1997 116-20(2)

ITAA 1997 Div 230

ITAA 1997 230-45

ITAA 1997 230-435

ITAA 1997 230-435(1)

ITAA 1997 230-435(3)

ITAA 1997 960-100(1)

ITAA 1997 960-100(2)

Commonwealth Inscribed Stock Act 1911

Commonwealth Inscribed Stock Act 1911 4

Corporations Act 2001

TAA 1953

Other references:

ASX Settlement Operating Rules

ATO references

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CGT asset
Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT events E1 to E9 - trusts
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special capital receipts

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