TR 92/D38 - Income tax: basis of assessment of interest derived and incurred by financial institutions

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This document has been finalised by TR 93/27.

Generated on: 28 November 2026, 03:37:13 AM

Draft Taxation Ruling
Income tax: basis of assessment of interest derived and incurred by financial institutions

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What this Ruling is about

1. This Ruling clarifies when interest derived and interest incurred by a financial institution is to be brought to account as income or is allowable as a deduction for the purposes of the *Income Tax Assessment Act 1936* ('the Act'). The Ruling proceeds on the general basis that interest received is assessable under subsection 25(1), and interest paid is deductible under subsection 51(1), to taxpayers that are financial institutions.

2. The types of financial instruments and investments to which this Ruling applies include:

- overdrafts, term loans, personal and other loans;
- interest bearing deposits; and
- securities issued or held by financial institutions.

3. This Ruling does not apply to interest rate swaps of the kind discussed in Taxation Rulings IT 2050 and 2682 nor does it have any application to 'qualifying securities' as defined in subsection 159GP(1) in Division 16E of Part III of the Act. Further, this Ruling does not apply to bills of exchange, promissory notes and other commercial paper issued at a discount to which Division 16E does not apply (for example, by reason of their term being

less than twelve months). This is because interest is not the same as discount and a distinction between discount and interest exists in the common law rule that interest accrues daily (see, for example, *Chow Yoong Hong v. Choong Fah Rubber Manufactory* (1961) 3 All ER 1163 at 1167; (1962) AC 209 at 217; *Willingale (H.M. Inspector of Taxes) v. International Commercial Bank Limited* (1978) 52 TC 242 at 269 & 273; *Torrens v. Commissioners of Inland Revenue* (1933) 18 TC 262 at 267; *Felt & Textiles of New Zealand Ltd v. Inland Revenue Commissioner (NZ)* (1968) 10 AITR 743 at 748).

4. Clarification of the appropriate time to return income and claim deductions for interest received and paid in advance by financial institutions will be the subject of a separate Ruling to issue shortly.

5. Similarly, timing issues in respect of interest derived by businesses that invest in certain fixed and variable interest securities, where such securities are purchased or sold cum interest rights will also be discussed in a separate Ruling to issue shortly.

Ruling

6. A distinction may be drawn between certain taxpayers that operate in the financial markets. On the one hand there are those that carry on business as lenders, financiers and investors by taking deposits and borrowing funds and then on-lending or investing those funds for income earning purposes. On the other hand there are those taxpayers that invest substantial amounts of money as part of their investment function but do not finance their operations to any significant extent with borrowed funds. Rather, their activities are financed by way of equity or deriving premiums that by their nature do not involve any interest expense. That is, in the latter circumstances borrowings play no, or only a limited, part in the business activities of the enterprise.

7. Whilst both kinds of taxpayers might generally be described as financial institutions this Ruling only applies to taxpayers that principally, and in the ordinary course of their business operations, derive assessable income by lending or investing funds obtained by way of deposit or borrowing. These

features make the accounting principle of matching expense to revenue an appropriate basis for such businesses to tax account for interest derived and incurred. Generally speaking, taxpayers that are not moneylenders would be excluded from the application of this Ruling.

8. Examples of taxpayers that fall within the restricted meaning of 'financial institution' used in this Ruling include banks, merchant banks, finance companies (including 'in-house' finance companies), building societies, credit unions and moneylenders. Examples of taxpayers that do not fall within the restricted meaning of 'financial institution' used in this Ruling include insurance companies (both general and life), approved deposit funds, cash management trusts, friendly societies and superannuation funds.

9. Paragraphs 22 to 30 of this Ruling discuss the common law principle that interest accrues *de die in diem* (day by day). The daily accruals method of accounting for interest income and interest expense generally adopted by financial institutions reflects that principle and is in accordance with generally accepted accounting practice in Australia. The daily accruals method is the appropriate basis on which financial institutions should bring interest income and expense to account for taxation purposes where the terms and conditions of the relevant contract indicate that the parties do not intend to disturb the ordinary rule that interest accrues on a daily basis over the period of the investment. Where the common law rule is altered by express agreement between a financial institution and its client, the time when interest is derived or incurred by that financial institution can only be ascertained having regard to the terms of the relevant agreement entered into between the parties to the transaction.

10. Taxation Ruling IT 2017 is now withdrawn.

Date of effect

11. This Ruling applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued. To the extent that this Ruling is concerned with changes in interpretation, those changes operate in favour

of taxpayers. Consequently, if a taxpayer has a private ruling which is inconsistent with this Ruling, then this Ruling will only apply to that taxpayer from and including the 1992-93 year of income unless the taxpayer asks that it apply (subject to any limitations imposed by statute) to earlier income years.

Explanations

Definition of a 'financial institution'

12. The nature of a taxpayer's income producing activities is fundamental in deciding when income is derived (cf. *The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited* (1938) 63 C.L.R. 108) (*Carden's case*). It is arguable that a similar principle is required with respect to interest outgoings and that a distinction ought to be drawn between taxpayers that are financial institutions and other taxpayers. Support for this view may be found in the decisions in *Alliance Holdings Limited v. FCT* 81 ATC 4637; (1981) 12 ATR 509 (*Alliance Holdings*) and *FC of T v. Australian Guarantee Corporation Limited* 84 ATC 4642; (1984) 15 ATR 982 (*AGC*) which rested to some extent on the nature of the particular taxpayers business.

13. The Australian Accounting Research Foundation discussion paper, *'Financial Reporting by Financial Institutions and Accounting for Financial Instruments'*, Discussion Paper No. 14 (1990) by Phillip Hancock, defines 'financial institutions' (at paragraph 1.03) to be:

> '...any institution, one of whose principal activities is to take deposits and borrow, with the objective of lending and investing and includes all the following types of institutions:
>
> Banks
> Merchant banks
> Finance companies
> Building societies
> Credit unions
> Pastoral finance companies
> Life insurance offices

General insurance offices
Pension and superannuation funds
Friendly societies
Cash management trusts
Co-operative housing schemes.'

14. However, in this Ruling a distinction is drawn between taxpayers that carry on business as lenders, financiers and investors by taking deposits and borrowing funds and then on-lending or investing those funds for income earning purposes, and those taxpayers that invest substantial amounts of money as part of their investment function but do not finance their operations to any significant extent with borrowed funds but rather by way of equity or premiums that by their nature do not involve any interest expense. That is, in the latter circumstances borrowings play no, or only a limited, part in the business activities of the enterprise. The distinction is best illustrated through an examination of the difference between the operations of a bank or building society and an insurance company.

15. Generally speaking, the business of a savings or trading bank includes accepting deposits from customers (with such deposits carrying interest); the payment of withdrawals on demand by customers; obtaining other funds by way of borrowing; and investing and lending deposited money and other borrowed funds. In speaking of a trading bank in *Commercial Banking Co. of Sydney Limited v. FC of T* (1950) 81 CLR 263 Dixon J (as he then was) said (at 304):

> 'A banker's business may be said to be that of dealing in money'.

In *Case P52* (1964) 14 TBRD 236 ; 11 CTBR (NS) 437 *Case 75* Mr R.C. Smith (Member), after referring to these remarks of Dixon J, added (at TBRD 237; CTBR 439):

> '...and in my opinion these words apply equally to the business of a savings bank as to that of a trading bank'.

Further, the No. 3 Board of Review in *Case F26* 74 ATC 132 at 155; (1974) 19 CTBR (NS) 291 *Case 44* found that the investment operations of a building society and its day to day dealings with its customers were for all practical purposes indistinguishable from much of the business of a savings bank.

16. In holding that the principal business of a bank was the lending of money, Dixon J in the *Commercial Banking Co. of Sydney case* said (supra at CLR 304):

> 'The profit-making side of his (a banker's) activities is in putting out the money so as to increase it, and that substantially means to obtain interest. If attention is riveted upon the relations of the banker to his customer and the amount of work done in that respect it might be thought that to say that the principal business consists of the lending of money is to ignore all the business done with customers whose accounts are in credit as well as much else besides. But if attention is riveted on the activities of banking in which the money is used or laid out it would seem correct to say that the decisively profit-making side of the business is concerned with the lending of money.' (Underline added)

17. In *FC of T v. Australian Mutual Provident Society* (1953) 88 CLR 450 the High Court rejected the argument put by a mutual life assurance company that its principal business was the lending of money. In the following passage from the joint judgment of Dixon CJ, Williams, Fullager and Kitto JJ (at 463-4), their Honours illustrate the distinction between the business of a bank and insurance companies:

> 'In the *Commercial Banking Co.'s Case* it was held that the principal business of a bank was the lending of money. The Society maintains that its principal business also is the lending of money. The argument was, in our opinion, rightly rejected by the board. The Society's principal business is the business of life assurance, that is to say, the making and performance of contracts to pay, in consideration of premiums paid to it, sums of money on death or on the expiration of a period. Its business differs radically from that of a banker. The lending of money is of the essence of the business of a banker. He provides many other facilities for his customers, but it may be said to be the characteristic of

> his business that he borrows money in order to lend it. If he ceased to lend money, the nature of his business (assuming it to survive) would radically change. A life assurance company lends money, and its lendings are very important, but they are not the essence of its business. They are operations ancillary to the main business, made primarily because the holding of large funds to cover contingent liabilities is a necessity of that business. If a life assurance company ceased to lend money, the nature of its business would not change. The position would simply be that it would have to charge larger premiums in order to maintain itself in a sound position. Interest derived by a life assurance company on money lent by it is, in our opinion, income from property and not income from personal exertion.' (Underline added)

18. It should be noted that the above distinction between the borrowing and lending aspects of the operations of banks and insurance companies should not be seen as derogating from the general principle governing the assessability of the profit (or conversely the allowability of losses) arising on the sale of investments by banks and insurance companies (cf. *Californian Copper Syndicate v. Harris* (1904) 5 TC 159 at 166; *Punjab Co-operative Bank Limited, Amritsar v. Commissioner of Income Tax, Lahore* (1940) AC 1055; *Colonial Mutual Life Assurance Society Limited v. FC of T* (1946) 73 CLR 604; and *Australasian Catholic Assurance Co. Limited v. FC of T* (1959) 100 CLR 502).

19. Hence, a 'financial institution' for the purposes of this Ruling is a taxpayer that principally, and in the ordinary course of its business operations, derives assessable income by lending or investing funds obtained by way of deposit or borrowing. These features make the accounting principle of matching expense to revenue an appropriate basis for such businesses to tax account for interest derived and incurred. Generally speaking, taxpayers that are not moneylenders would be excluded from the application of this Ruling.

20. Examples of taxpayers that clearly fall within the restricted meaning of 'financial

institution' used in this Ruling include banks, merchant banks, finance companies (including 'in-house' finance companies), building societies, credit unions and moneylenders. Examples of taxpayers that do not fall within the restricted meaning of 'financial institution' used in this Ruling include insurance companies (both general and life), approved deposit funds, cash management trusts, friendly societies and superannuation funds.

21. Some doubt may exist in particular cases as to whether this Ruling applies to a group holding company lending money to a subsidiary or other 'in house finance company'. In relation to who is a moneylender for the purposes of paragraph 63(1)(b) of the Act we accept that a moneylender need not necessarily be ready and willing to lend moneys to the public at large or to a wide class of borrowers. It would be sufficient if the taxpayer lends moneys to certain classes of borrowers provided it does so in a business-like manner with a view to yielding a profit from it. See generally paragraphs 42 to 46 of Taxation Ruling TR 92/18.

The nature of interest

22. An appreciation of the nature of interest is important in determining the time at which interest income is derived and interest expense incurred by a financial institution for taxation purposes.

23. Whilst 'interest' is given a specific meaning in a number of provisions of the Act it's meaning is not defined for the purposes of the Act generally. It is therefore necessary to have regard to the nature of interest in common law.

24. Interest is of two kinds, namely, interest agreed to be paid on a loan, and interest payable as damages for the non-payment of a debt or other sum of money on the proper day. See Jowitt's *Dictionary of English Law,* 2nd edition.

25. At law, interest accrues day by day (that is, *de die in diem*) even if payable only at intervals (cf. *The State of South Australia v. The Commonwealth of Australia* 92 ATC 4066 at 4072; (1992) 23 ATR 10 at 19). Interest is therefore apportionable under the general law in respect of time (cf. *Halsbury's Laws of*

England, 4th ed., Vol. 32 at para 106; Vol. 16 at para 1250; *Conveyancing Act 1919 (NSW)*, subsection 144(1)).

26. Jowitt's *Dictionary of English Law* 2nd ed. provides a functional description of interest:

> 'Interest is calculated at a rate proportionate to the amount of principal and to the time during which the non-payment continues...'

27. In *FC of T v. The Myer Emporium Limited* (1987) 163 CLR 199 the Full High Court restated a basic concept of interest. At page 218 it stated:

> '...interest is regarded as flowing from the principal sum (*Federal Wharf Co. Ltd v. DFCT* (1930) 44 CLR 24 at 28) and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum: *Riches v. Westminster Bank Limited* (1947) AC 390 at 400.'

28. Moreover, the courts have also regarded interest to be a reward earned for the service of lending, the interest being earned as money is left outstanding (cf. *Commissioner of Inland Revenue v. The National Bank of New Zealand* 77 ATC 6001 at 6023, 6026 & 6032; (1977) 7 ATR 282 at 295, 298 & 306; *Willingale*, supra at 271). In *Commissioner of Inland Revenue v. The National Bank of New Zealand* Cooke J related interest to the reward for the provision of a service when he stated (supra at ATC 6023; ATR 295):

> 'In relation to interest on a loan the service is performed when the principal is left outstanding.' (Underline added).

29. It also appears that the common law principle that interest accumulates day by day may be overridden by the terms of a suitably worded loan agreement. In the *AGC* case Beaumont J, in analysing the construction of the 'Special Conditions' governing a debenture issue by the taxpayer, said (at ATC 4659-60; ATR 1004-5):

> 'It is possible to imagine a case where, on the true construction of their contract, parties make provision for the payment or crediting of a special kind of premium, entitlement to which springs into existence, for the

> first time at a remote future date. It would be a feature of such a contract that, if it did not run its full term...the lender would have no entitlement to interest as such... Certainly, he could not claim for interest accrued due at that point of time.' (Underline added)

His Honour then concluded (at ATC 4660; ATR 1005):

> 'The language employed emphasises that the primary objective of the draftsman of the Special Conditions was to defer the payment or crediting of interest until redemption... In my view, consistently with his primary objective, the draftsman did not intend to disturb the ordinary position that interest accrues due on a daily basis over the period of the investment. It is significant, in this regard, first, that what was being dealt with was interest in the conventional sense and, secondly, that it was to be calculated from the date of investment.' (Underline added)

30. In *Willingale* Lord Fraser of Tullybelton (at TC 273), in distinguishing a discount from interest also indicated that interest would not always accrue daily but may accrue over specified periods:

> 'In my opinion there is an essential difference between interest and discount, so much so that to speak of 'earning' discount, seems to me wrong. Interest accrues from day to day, or at other fixed intervals, but discount does not.' (Underline added)

Time of deductibility of interest expenditure

31. To determine when an outgoing is deductible under subsection 51(1) it is necessary to determine when that outgoing is 'incurred'.

32. Generally speaking, the courts have held that a loss or outgoing is incurred in the year in which there is a presently existing liability to discharge an obligation which is due. That is, the loss or outgoing must be a presently existing pecuniary obligation that has become due irrespective of whether it is payable now or in the future; a *debitum in praesenti solvendum in futuro,* viz. an amount owed at the present time, payable (or to be performed) in the future: *FC of T v. James Flood Pty Limited* (1953) 88 CLR 492 at 506; *Nilsen Development Laboratories Pty Limited & Ors v. FC of T* 81 ATC 4031 at 4034-7; (1981) 11 ATR 505 at 508-12; *AGC*, supra at ATC 4658; ATR 1002.

33. Support for the view that financial institutions should adopt the daily accruals basis of claiming interest expense may be found in the *Alliance Holdings* decision and in *AGC* (supra). Both cases involved finance companies and dealt with the timing of deductions for interest expense under subsection 51(1). Both companies accounted for their income and expenditure on an accruals basis. The interest on the relevant debentures was not credited or paid to the debenture holders but credited to an accrued interest account.

34. In both cases the courts found a presently existing liability and then turned to generally accepted accounting practice for assistance in allocating the deductible interest expense to a particular income tax period.

35. The taxpayer company in *Alliance Holdings* carried on the business of a financier, its activities being mainly the borrowing and lending of money. Its income was substantially derived in the form of interest received. In accordance with generally accepted accounting principles, the taxpayer used the basic accountancy concept of matching costs and revenue ('the matching concept') and set-off its cost of borrowing against income received from the on-lending of those funds.

36. Woodward J decided that during the year of income the finance company had come

under a present liability to pay interest in the future. That being the case the 'loss or outgoing incurred' in that year could properly be measured by applying the accruals basis of accounting practice under which the amount of interest was appropriated to the particular year of income.

37. The Court accepted that the company's auditors would have taken issue with the exclusion of accrued income from the company's accounts and was clearly influenced by the appropriateness of a finance company using the accounting concept of 'matching' expenses with income. This is clear in the following passage of his Honour's judgment (at ATC 4640; ATR 512):

> 'The method of accounting adopted by the appellant is the "accrual basis" and in accordance therewith the cost of borrowing funds has been set off against the income received from the "on-lending" of those funds.' (Underline added)

The approach adopted by the taxpayer did not force an interpretation of section 51 which the section could not sustain.

38. His Honour then examined the role of commercial and accounting principles and practices, referring to statements by the courts in *James Spencer & Co. v. I.R. Commrs* (1950) SC 345 at 352 and *FC of T v. James Flood Pty Limited* (supra) at CLR 506, before stating (at ATC 4641; ATR 513):

> 'It may be that the procedure adopted by the taxpayer, based upon the use of the basic concept of matching costs and revenues over a particular period, produces a result coincidental with an interpretation of the effect of subsection 51(1) in accordance with the authorities. (See also *Nilsen Development Laboratories Pty Limited & Ors v. FC of T* 79 ATC 4520, per Deane J, at 4526; 81 ATC 4031.)'

Later (at ATC 4643; ATR 515-6) his Honour concluded:

> 'The obligation (to pay principal and interest) was created at the time the contract was made. The debt however

> was not payable until some time in the future...I am satisfied that in respect of the deductions claimed by the taxpayer there was in each relevant tax year a present liability to pay the determined interest at a future date...'

39. The Supreme Court of NSW, at first instance, in *Australian Guarantee Corporation Limited v. FC of T* 84 ATC 4024; (1983) 15 ATR 53 and the Full Federal Court on appeal in *AGC* (supra) again decided that the relevant deferred debenture interest expense was incurred by a finance company on a daily accruals basis.

40. Moreover, in an approach similar to that taken by the Court in *Alliance Holdings*, both the Supreme and Federal Courts in the *AGC* cases paid due deference to generally accepted accounting principles, and both Courts decided that the amount of interest which was deductible to the finance company in the year of income was only that amount which was referable to the year in question calculated on a daily accruals basis.

41. As was the case in *Alliance Holdings*, the Federal Court decision in *AGC* appears to be confined to financial institutions in the restricted sense used in this Ruling. The taxpayer in *AGC* was a subsidiary of a bank that carried on business as a financier. The taxpayer's business entailed making secured and unsecured advances and the provision of financial accommodation to its customers. The taxpayer borrowed funds in a number of ways in order to provide funds to its customers. Toohey J said (supra at ATC 4649; ATR 991):

> 'The notion of "matching " is of particular relevance in the present case because of the taxpayer's general activities in the borrowing and lending of money.'

42. When the matter originally came before the Supreme Court, Lee J referred to the common law rule that interest accrues on a daily basis. However, the *ratio decidendi* of the Court's judgment does not appear to be founded on that principle. His Honour acknowledged the authorities which state that accounting principles cannot be determinative as to when

an outgoing is 'incurred' for tax purposes but then stated (supra, at ATC 4033-4; ATR 65):

> 'But a conclusion that, where there is a presently existing liability to pay interest in the future, the amount of interest accruing each year, up to the date of maturity, is "incurred" during the respective years, does not mean that accounting practice is being used as a substitute for the true meaning of "incurred" in subsection 51(1). All it means is that accounting practice is identifying in respect of that liability, which is a present liability to pay the whole of the interest at a future time, the amount which is to be treated as an outgoing "incurred" during each year of income... In this situation it seems to me that accounting practice can be resorted to to identify the extent to which a presently existing liability to be discharged in another year, should be treated as an "outgoing incurred" in the year of income.' (Underline added)

And later (at ATC 4034; ATR 66):

> 'In the present case accountancy practice looks to the existing liability to pay the whole of the interest in the future, and shows the manner in which part of that liability may be appropriately treated as an expense "incurred" during each year of income.' (Underline added)

43. In dismissing the Commissioner's subsequent appeal, the Full Federal Court concluded that the method by which the taxpayer had calculated the amount of accrued interest expense referable to a particular income tax year should be accepted. Toohey J does not appear to have found it necessary to base his decision on the common law rule that interest accrues on a daily basis. Rather, and with the concurrence of Beaumont J (supra at ATC 4660; ATR 1005), his Honour had regard to the relevance of accountancy concepts and principles in determining the appropriate tax expense. He said (supra at ATC 4649; ATR 992):

> 'This Court should be slow to disallow a method of calculating the amount of an outgoing if what is claimed is fairly referable to the year in question. In

> my view, the amount claimed by the taxpayer as interest on deferred interest debentures for the year ended 30 September 1978 was an outgoing incurred by the taxpayer in the relevant year. It was calculated in accordance with sound accounting practice, designed to give a true picture of the taxpayer's financial operations, and it was an approach not precluded by the language of the Act. It is insufficient objection to that approach to say that it is not known when interest will in fact be paid. The amount claimed as a deduction was, in terms of subsection 51(1), incurred in the relevant year in the sense that the taxpayer subjected itself to a liability which it assessed according to a method fairly designed to reflect the extent of the liability for the year in question.' (Underline added)

44. McGregor J also appears to have found accountancy practice persuasive. In finding for the taxpayer his Honour observed (supra, at ATC 4657; ATR 1001):

> '... the accountancy evidence here was used and, with respect, correctly, by the learned primary Judge in reaching his decision. With due deference I am similarly assisted.'

45. Daily accruals is the generally accepted accounting method for reflecting the common law nature of interest and allocating interest expenditure to relevant periods. Therefore, subject to the terms and conditions of the relevant loan agreement not disturbing the common law rule that interest accrues on a day by day basis, the decisions in *Alliance Holdings* and *AGC* support the view that allowable deductions for interest expenditure by financial institutions should be measured using the daily accruals method. In this context interest outgoings are incurred on a daily accruals basis.

Time of derivation of interest income

46. In determining at what point of time interest received by a financial institution is assessable under subsection 25(1) it is necessary to determine when the interest is

'derived'. The Act does not define the word 'derived' and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer.

47. The time at which income is derived for tax purposes depends, in part, upon the nature of the taxpayer and the particular income producing activity. This encompasses a careful analysis of the facts and circumstances pertaining to the whole of the taxpayer's enterprise, as well as consideration of general industry practice and current accounting principles. Consideration of all those factors determine the appropriate method by which a taxpayer should bring income to account for tax purposes: *Carden's case* (supra); *Barratt & Ors v. FC of T* 92 ATC 4275 at 4279; (1992) 23 ATR 339 at 344)

48. It is also well established that unless the Act makes some specific provision on the point, the amount of income derived is to be determined by the application of ordinary business and commercial principles, and that the method of accounting to be adopted depends upon its actual appropriateness as a method which is 'calculated to give a substantially correct reflex of the taxpayer's true income': *Carden's case*, at page 154; *Brent v. FC of T* 71 ATC 4195 at 4200; (1971) 2 ATR 563 at 570).

49. The relevance of accountancy and business practice to the derivation of 'suspended interest' by a bank, was addressed by the New Zealand Court of Appeal in *Commissioner of Inland Revenue v. The National Bank of New Zealand* (supra). In that case the Court had regard to the judgment of Dixon J in *Carden's case* as well as various other Australian cases. Cooke J summed up his view of the authorities in the following terms:

> 'Taken as a whole the Australian cases show that accountancy evidence may be important, and <u>they emphasise that in every case the ideal is what Dixon J called "a substantially correct reflex" of the particular taxpayer's income</u>...' (Underline added)

50. While the courts have described interest as being 'earned' (refer to the earlier discussion on this point at paragraph 28), the term 'earned' is not necessarily equivalent in meaning to 'derived' (cf. *Brent v. FC of T*, supra at ATC 4200; ATR 570). Nevertheless,

when considering the conditions under which deferred interest debentures issued by the taxpayer would earn interest for their holders in *AGC*, Beaumont J discussed the receipt of interest in the following terms (at ATC 4659; ATR 1003):

> 'In *In re Rogers' Trusts* (1860) 1 Dr. & Sm. 338; 62 ER 408, Sir R.T. Kindersley V.-C., in holding that interest was apportionable, said (at Dr. & Sm. p. 341; ER p. 409):
>
> > "In the present case the interest payable on the debentures, though payable half-yearly, is not an entirety, but is an accumulation of each day's interest, which accrues *de die in diem*; and which, though not presently payable, is still due."
>
> 'It must be accepted, as Lord Russell of Killowen observed in *Willingale*... that "earn" is not a word of universal application in the same sense in all circumstances. In its relevant dictionary meaning, "earn" means "to gain as a due return or profit" (*Macquarie Dictionary*). But the immediate question is one of timing, namely to determine when the interest was "earned", and the ordinary meaning of "earn" is equivocal in that sense: it describes the fact of gaining a return without necessarily indicating the period to which it is referable. 'Although the bare statement that interest is, or will be, "earned" is not itself determinative of the time at which or the period during which interest will be derived, ordinarily, where interest is accruing from day to day, it is, I think, appropriate to describe that interest as being "earned" on such a daily basis in point of time, even if not payable until a later date. Further, in my opinion, the period in which interest is accruing due may properly be regarded as the period in which interest is thus being earned.' (Underline added)

51. The commercial accounts of trading operations do not represent the primary position from which an investigation of income

for taxation purposes begins (cf. *Commissioner of Inland Revenue v. The National Bank of New Zealand*, supra at ATC 6016; ATR 286. *F C of T v. Thorogood* (1927) 40 CLR 454 supports the view that there is no principle of law that makes bookkeeping entries decisive when derivation of income is in issue. The correct approach is to take into consideration 'sensible business considerations' (per Starke J in *Perrott v. DC of T (NSW)* (1922) 40 CLR 450 at 454) and to use 'business good sense': *Arthur Murray (NSW) Pty Limited v. FC of T (Arthur Murray)* (1965) 114 CLR 314 at 319.

52. Moreover, while commercial and accountancy practice cannot be substituted for the tests contained in the relevant provisions of the Act, the courts have found it appropriate to place reliance upon the concepts of business and the principles and practices of commercial accountancy in the ascertainment of income and expenditure. See, for example, *FC of T v. James Flood Pty Ltd*, supra at CLR 506-7; *Carden's case*, supra, per Dixon J at CLR 152-3; *AGC*, supra, per Toohey J at ATC 4649; ATR 992; and *Hooker Rex Pty Limited v. FC of T*, 88 ATC 4392; (1988) 19 ATR 1241 per Sweeney and Gummow JJ at ATC 4399; ATR 1248.

53. The High Court gave considerable weight to accounting practice in *Arthur Murray* (supra) when considering whether money received in advance of services to be rendered (dancing lessons) was derived for the purposes of subsection 25(1) of the Act. The Court noted that income derivation involves more than the ascertainment of book-keeping methods. It also expressed the view (at CLR 318);

> 'The ultimate inquiry... must be whether that which has taken place, be it the earning or the receipt, is enough by itself to satisfy the general understanding among practical business people of what constitutes a derivation of income. A conclusion as to what that understanding is may be assisted by considering standard accountancy methods, for they have been evolved in the business community for the very purpose of reflecting received opinions as to the sound view to take of particular kinds of items.'

See also *RACV Insurance Pty Limited v. FC of T* 74 ATC 4169; (1974) 4 ATR 610; *Commercial Union*

Assurance Company of Australia Ltd v. FC of T 77 ATC 4186; (1977) 7 ATR 435; *International Nickel Australia Limited v. FC of T* (1977) 137 CLR 347 at 366-7; *FC of T v. Cyclone Scaffolding Pty Limited* 87 ATC 5083; (1987) 19 ATR 674).

54. As pointed out by Dixon J in *Carden's case* (supra at CLR 152) and the High Court in *Arthur Murray* (supra at CLR 318), although ordinary accounting principles and practice are not determinative of the issue, they are nevertheless relevant and may be influential. There are many examples where the law's view of derivation of income coincides with accountancy principles relevant to that issue (cf. *J. Rowe & Son Pty Limited v. FC of T* (supra) and *Commrs of I.R. v. Gardener Mountain and D'Ambrumenil Limited* (1947) 29 TC 69; *Arthur Murray* (supra)).

55. Where the matter is not specifically addressed by legislation the authorities establish that the relevant tax accounting method is a question of law to be determined on the facts of the particular case. The Courts will nevertheless have regard to accounting and business principles and practices to assist in that determination with considerable weight being given to what is appropriate in the circumstances. (See, for example, *Henderson v. FC of T* (supra); and *FC of T v. Firstenberg* 76 ATC 4141; (1976) 6 ATR 297). Moreover, the relevance of established accounting and commercial principles in determining when income is derived does not diminish even though two or more generally accepted methods may exist in practice. (cf. *FC of T v. Australian Gaslight Co.* 83 ATC 4800 at 4806; (1983) 15 ATR 105 at 112).

56. Accounting practice has changed over the years to reflect the increasing complexity of financial transactions and the greater reliance on credit. (See, for example, *Henderson v. FC of T*, supra per Windeyer J at CLR 626). However, while accountancy methods have changed, the fundamental accounting principle of matching revenue and costs in order to give a true reflection of an entity's performance over specified periods has not altered. For example, public entities are bound to adopt existing accounting standards in the recognition of income for reporting purposes. Those standards specifically require that income should be brought to account on an

accrual basis so as to match income with the period to which it is attributable. This accords with approved accounting standard *ASRB 1001: Accounting Policies - Disclosure* (esp. paras 1001.10 & 1001.31); and Australian Accounting Standard *AAS 6: Accounting Policies: Determination, Application and Disclosure* (esp. paras 2(b), 7 & 14). 'Accrual basis' for the purposes of the accounting standards means that items are brought to account as they are earned or incurred (and not as money is received or paid) and included in the financial statements for the accounting periods to which they relate.

57. The courts adopted the daily accruals method of measuring interest expense deductions in respect of the two finance company taxpayers in *Alliance Holdings* (supra) and *AGC* (supra). The finance companies in both cases used the basic accountancy concept of matching costs and revenue. Notwithstanding that the courts in those cases dealt with matters of deductibility in respect of interest payable for the purposes of subsection 51(1), similar assistance may nevertheless be drawn from the matching principle of accountancy in determining when interest income is earned and derived for taxation purposes by a financial institution.

58. Paragraphs 22 to 30 of this Ruling explain the common law principle that interest accrues *de die in diem* (day by day). The daily accruals method of accounting for interest income generally adopted by financial institutions reflects that principle and is in accordance with generally accepted accounting practice in Australia.

59. Subject to the terms of the agreement between the parties not disturbing the ordinary rule that interest accrues on a day by day basis, the authorities support the view that, in the case of a financial institution, interest arising from the making of loans and investments generally accrues as income earned on a daily basis. The dates specified in the contract for the payment of interest, by the client of the financial institution, are dates which are used for the convenience of both the client and financial institution, detailing when the payments are to be paid or credited/ received or receivable. In most contracts the interest is an accumulation of each day's interest which accrues, and though not presently payable, is still due.

60. Accordingly, where interest is accruing due to a financial institution on a daily basis then it is earned by that financial institution on a daily basis even though it may not actually be received until a later date. In other words, interest income may be derived on a daily accruals basis notwithstanding that the payment of interest has been deferred or, in the words of Barwick CJ in *Henderson v. FC of T* (1970) 119 CLR 612 at 651, notwithstanding that the borrower has been afforded a period of time to pay. Modern accounting and commercial principles and practice reflect the common law nature of interest and therefore support the view that interest income is derived by a financial institution as it accrues on a day by day basis.

61. Daily accruals is the appropriate method for a financial institution to bring to account interest income for taxation purposes where the terms and conditions of the relevant contract indicate that the parties do not intend to disturb the ordinary rule that interest accrues on a daily basis over the period of an investment. However, where the common law rule is altered by express agreement between a financial institution and its client, the time when the particular interest is derived by that financial institution can only be ascertained by an analysis of the terms of the relevant loan agreement entered into between the parties to the transaction.

Commissioner of Taxation

17 December 1992

ISSN 1039 - 0731

ATO references
NO 92/6764-6
BO NOR J5/186/3-1

Not previously released to the public in draft form

Price $1.70

FOI index detail
reference number

subject references
- allowable deductions
- assessable income
- interest
- financial institutions

legislative references
- ITAA 25(1); ITAA 51(1); ITAA 63(1)(b); ITAA 159GP(1); ITAA Div. 16E; Conveyancing Act 1919 (NSW) 144(1)

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