TR 93/D43 - Income tax: traditional securities

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Draft Taxation Ruling
Income tax: traditional securities

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What this Ruling is about

1. This Ruling considers a number of interpretive matters in relation to section 26BB and section 70B of the *Income Tax Assessment Act 1936* (the Act). These sections deal with traditional securities.

2. A traditional security is, broadly, a security that is not issued at a discount of more than 1.5%, does not bear deferred interest or is not capital indexed. A traditional security may be, for example, a bond, a debenture, a deposit with a financial institution or a secured or unsecured loan.

3. A gain made on the disposal or redemption of a traditional security is included in the assessable income under section 26BB. Section 70B provides that a loss on disposal or redemption of a traditional security may be an allowable deduction.

Ruling

4. We have formed the following views about a number of interpretive issues in relation to the traditional securities provisions of the Act:

i) in the usual case of a unit in a property or cash management public unit trust, the unit is not within paragraphs (a) or (d) of the definition of security in subsection 159GP(1) of the Act. It cannot therefore be a traditional security. That is not to say, however, that units reflecting certain kinds of contractual arrangements embodied within a unit trust structure will not satisfy the definition of security. If so, and the security otherwise satisfies the definition of 'traditional security' in

subsection 26BB(1), any gain or loss upon the disposal or redemption of the unit may be assessable or deductible under section 26BB or section 70B respectively;

ii) a guarantor's right of indemnity against a principal debtor is either contractual in nature or may be a restitutionary remedy. An indemnity contract between a debtor and a guarantor is not within paragraphs (a) or (d) of the definition of security in subsection 159GP(1) of the Act. It cannot therefore be a traditional security. The restitutionary right that a guarantor may have against a debtor is not within paragraph (a) of the definition of security. As the right is not founded in contract it is not within paragraph (d) of the definition. It cannot, therefore, be a traditional security;

iii) the forgiveness or waiver of a debt that is a traditional security constitutes, [subject to subsection 70B(5)], a disposal of the security provided the forgiveness or waiver is undertaken by way of a formally executed deed, under an agreement for which consideration was given or in circumstances where the debtor is entitled to allege an estoppel. A company resolution, with or without a corresponding write-off in its books of account, is not sufficient to constitute the disposal of a traditional security;

iv) a traditional security issued by a company that has gone into liquidation is disposed of when the liquidator has made a final payment to the holder of the security. Alternatively, if no payments are to be made, a disposal will be taken to have occurred when the liquidator officially notifies holders that this is the case;

v) a security will not be taken to have been disposed of at the time of the death of the holder. A disposal occurs when the executor of the deceased estate disposes of the security otherwise than by transferring the security to a beneficiary of the estate, or the security is redeemed;

vi) subsection 70B(3) enables the Commissioner to substitute an arm's length amount as consideration for the acquisition of a traditional security or as consideration in respect of the disposal of a traditional security. In determining the arm's length consideration that will be substituted as the acquisition or disposal consideration a discounted cash flow analysis will be used where there is no established market from which the arm's length value can be ascertained;

vii) Part IVA will be applied to certain loan forgiveness arrangements entered into between non-arm's length parties

where the requirements of the Part are satisfied. Part IVA will not apply to a 'wash sale' of a traditional security where:

(a) absolute control and ownership of the security is validly and effectively transferred;

(b) the security is transferred at a true market value; and

(c) there is no intention, arrangement or understanding at the time of transfer that the security is to be re-acquired.

viii) the amount of any 'gain' on the disposal or redemption of a traditional security is the difference between the consideration for the acquisition of the security and the consideration received on the disposal of the security. Any costs associated with the acquisition or disposal may be deductible under subsection 51(1) if the tests for deductibility are otherwise satisfied;

ix) for the purposes of section 21 of the Act, the money value of shares received as consideration for the disposal of a traditional security is their market value at the time they were received;

x) a gain or loss made by the issuer of a traditional security when redeeming the security is not assessable under section 26BB or deductible under section 70B; and

xi) a 'deposit' within the meaning of paragraph (b) of the definition of security in subsection 159GP(1) includes a fixed or term deposit and a current or savings account with a financial institution. A traditional security that is a fixed or term deposit is acquired when the contract between the bank and the depositor is made. A traditional security, being the debt due to a current or savings account holder, is acquired when the account is opened.

5. Our policy in relation to penalties and interest on understatements of taxable income in tax returns for the 1991-92 income year where an amendment is made after 30th June 1992 is set out in Taxation Ruling TR 92/10. Broadly, the principles of the self assessment penalty legislation and changes to the section 170AA rate of interest are to apply. The principles contained in Taxation Ruling IT 2517 will apply to income tax returns for income years prior to 1991-92.

Date of effect

6. 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

7. Section 26BB and section 70B were introduced into the Act by the *Taxation Laws Amendment Act (No. 3) 1989* and apply to traditional securities acquired after 10 May 1989. Subsection 160ZB(6) was also enacted at that time. It provided that capital gains and capital losses were not to be taken to have accrued or to have been incurred on the disposal of a traditional security.

8. Section 70B has since been amended, with effect from 1st July 1992, to prevent deductions being allowable in some circumstances for a capital loss on the disposal or redemption of a traditional security that is attributable to the inability or unwillingness of the issuer to discharge its obligations to make payments under the security. Losses incurred on the forgiveness of loans are no longer treated as deductible losses.

Securities

9. Sections 26BB and 70B may be contrasted with the provisions of Division 16E of the Act which subject certain securities to an accruals taxation regime. A number of terms used in sections 26BB and 70B have the same defined meaning as terms used in Division 16E.

10. Division 16E was enacted in response to an increase in certain kinds of investments and other structured financial transactions which deferred the payment of income under the transaction to the investor. The kinds of instruments used or financial transactions entered into became known collectively as 'discounted and other deferred interest securities'. There were tax deferral advantages associated with the use of these securities by comparison with traditional interest-bearing securities. The provisions of Division 16E were designed to eliminate those tax deferral advantages.

11. A feature of the Division is the use of the term 'security'. It is defined in subsection 159GP(1):

> ' "**security**" means-
>
> (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
>
> (b) a deposit with a bank, building society or other financial institution;
>
> (c) a secured or unsecured loan; or
>
> (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured;'

12. The Explanatory Memorandum accompanying the *Taxation Laws Amendment Act (No. 2) 1986* which introduced Division 16E into the Act states (at p. 58):

> ' "security" has been defined very widely, and includes items that may not be usually regarded as securities, e.g., contracts, so as to encompass various arrangements that may give rise to a deferral in the payment of income...'

13. The Division applies to securities with certain characteristics. They are called 'qualifying securities'. A qualifying security is, broadly, a security issued after 16 December 1984 for a period that is reasonably likely to exceed 12 months and which is issued at a discount of more than 1.5%.

14. The mischief which the Division is designed to overcome is the deferral of income. In contrast, sections 26BB and 70B are not concerned so much with questions of timing but, rather, with the characterisation of certain receipts and losses as being assessable income or allowable deductions.

15. It was intended that sections 26BB and 70B would apply upon the disposal or redemption of a security to gains and losses attributable to changes in the value of the security due to movements in interest rates or other market adjustments. In one sense the gain or loss due to those changes is the equivalent of a return on funds invested, the return being of a revenue nature. It has always been difficult to characterise gains and losses made in respect of the redemption of securities issued or redeemable at a discount or premium that otherwise paid periodic interest. Much depended on the circumstances of each case. See, for example, the speech of Lord Green MR in *Lomax v. Peter Dixon & Co Ltd* [1943] 2 All ER 255. With traditional securities ordinarily paying commercial rates of interest, necessarily issued at or near par and redeemable at their face value, any profit or loss on disposal would, except in the most unusual

circumstances, have a revenue rather than a capital character. Sections 26BB and 70B were intended to provide this result in most cases.

16. The method adopted in sections 26BB and 70B was to define the relevant kind of receipts and losses and then include them in the assessable income or allow a deduction as the case may be. This was done by using the term 'security' as defined in Division 16E and then distinguishing Division 16E (qualifying) securities from section 26BB and section 70B (traditional) securities.

17. It was not intended that gains or losses of a genuinely capital kind would be affected by the traditional securities rules contained in sections 26BB and 70B. The above mentioned amendments to section 70B (see paragraph 8 above) are designed to make certain that losses of capital are not deductible under that section. Rather, they may be taken into account under the capital gains and capital losses provisions of the Act in calculating a taxpayer's net capital gain in a year of income.

18. The following issues have been raised about the scope of the definitions used in the traditional securities provisions and the operation of, in particular, section 70B of the Act.

Is a unit in a public unit trust a 'traditional security'?

19. We have been asked whether units held by investors in various public unit trusts fall within the definition of 'traditional security' in subsection 26BB(1) of the Act. The units may be held in cash management trusts or in property trusts.

20. For a unit in a unit trust to be a traditional security it first has to satisfy the definition of 'security' in subsection 159GP(1): see paragraph 11 above. Clearly, a unit is not within either paragraph (b) or (c) of the definition of security.

21. A unit in a public unit trust is not a listed item in paragraph (a) of the definition of security so it may only come within the term 'or other security' in that paragraph. The Explanatory Memorandum doesn't comment on the use of the term 'or other security' but states (at p. 13):

> 'Paragraph (a) of the definition refers to items that are usually taken to be a security...'

22. In modern times the word security is used in a number of quite distinct ways. In *Singer v. Williams* [1920] All ER 819 Lord Cave said (at p. 822):

> 'The normal meaning of the word "securities" is not open to doubt. The word denotes a debt or claim the payment of which

> is in some way secured. The security would generally consist of a right to resort to some fund or property for payment...when the word is used in its normal sense some form of secured liability is postulated.'

Paragraphs (c) and (d) of the definition in subsection 159GP(1) refer to loans and other contracts and indicate that they may or may not be secured. This is using the word 'secured' in the manner just described above. See also E.I. Sykes and S. Walker, *The Law of Securities,* 4th Edition, 1993, Law Book Company, at p. 3.

23. Another form of usage is found in, for example, legislation in relation to the securities industry. Sykes and Walker (supra) indicate that the legislation 'merely adopts its longstanding employment to indicate marketable interests bought and sold on the stock exchange...'. The *Corporations Law 1989* (Cwth) contains a definition of 'securities' in section 92 where the term means *inter alia*:

> '(a) debentures, stocks, or bonds issued or proposed to be issued by a government; or
>
> (b) shares in, or debentures of, a body corporate or an unincorporated body;...'

24. Edna Carew, *The Language of Money,* 1987, Allen & Unwin, states (at p. 217):

> 'In the context of financial markets, "securities" are written undertakings securing repayment of money. They are typically documents such as bonds, bills of exchange, promissory notes or share certificates which establish ownership or payment rights between parties.'

25. H.A.J. Ford, G.W. Hinde and M.S. Hinde, *Australian Business Dictionary* 1985, Butterworths, define 'securities' more widely as:

> 'In the securities industry this term includes shares, stock, debentures, unsecured notes, bonds, options, rights and interests under unit trusts of various kinds.'

26. Finally, the context in which the word is used may require yet a wider purview. For example, the word security is capable of describing an interest such as ground-rent *(Re Tapp and London and India Docks Company's Contract* (1905) 74 LJ Ch 523) and has been said to be a synonym for the word investment. See *Re Raynor* [1904] 1 Ch 186 and *Re Gent and Eason's Contract* [1905] 1 Ch 386.

27. It is arguable that the words 'or other security' in paragraph (a) of the definition in subsection 159GP(1) are not able to be read *ejusdem generis* with the preceding words in the paragraph. This is because of the variety of *genera* described therein. See for example *VTBR Case S1* (1979) 10 ATR 795 in respect of the meaning to be given to the

term 'any other securities of a corporation' in the context of an inclusive definition of 'debenture' in subsection 5(1) of the *Companies Act 1961* (Vic).

28. In *Knightsbridge Estates Trust Ltd v. Byrne* [1940] All ER 401 the House of Lords discussed the definition of 'debenture' in section 380 of the English *Companies Act 1929*. The word was defined to include 'debenture stock, bonds and any other securities of a company ...'. Lord Romer stated (at p. 411):

> 'It was contended on behalf or the appellants, however, that the words "any other securities" should be construed as referring only to securities *ejusdem generis* as the genus to which debentures belong. All I can say about that is that, if no one seems to know exactly what "debenture" means, no one can be expected to know what is *ejusdem generis* with it. Indeed, the very fact that no one seems to know exactly what "debenture" means indicates pretty plainly that "debenture" is itself the name of a genus, and not of a species. In my opinion, the words "any other securities" mean what they say, and include all other securities of any kind whatsoever.'

Accordingly, 'any other securities ' was held to include a mortgage of land. In *VTBR Case S1* (supra) it was held to include a mortgage of a chattel.

29. Having regard to the above discussion, and whilst appreciating the difficulty of finding one genus in paragraph (a), it is our view that the term 'or other security' in the context in which it is used only encompasses instruments that evidence an obligation on the part of the issuer or drawer to pay an amount to the holder, whether during the term of the instrument or at its maturity. We have drawn this conclusion because each of the listed instruments in paragraph (a) evidences such an obligation. This view is broadly consistent with the usage suggested by Carew (supra) that securities are written undertakings securing the repayment of money.

30. Accordingly, because a unit holder does not obtain an instrument that evidences an entitlement to the payment of a sum of money during the currency of the instrument or at its maturity in the same sense as the other kinds of listed instruments in paragraph (a) of the definition of security, a unit is not within the term 'or other security'.

31. It is arguable that paragraph (d) of the definition of security may encompass units in a public unit trust. That is, depending on the circumstances, the relationship of the unit holder and the manager of the trust may be contractual in nature. If so, there may exist a 'contract ... under which a person is liable to pay an amount or amounts, ...'

32. H.A.J. Ford, 'Public Unit Trusts', in *The Law of Public Company Finance,* eds R.P. Austin & R. Vann, 1986, Law Book Company, stated (at p. 401):

> 'So far as legal relations between the manager and the unit holders are concerned they would appear to arise from the acceptance of the application for units made by an investor to the manager ... By the common form of application the applicant agrees to be bound by the provisions of the trust deed and the terms of the offer of units. The manager's acceptance of the application and the allotment of units is likely to be regarded as a contract on the terms of the trust deed so far as it imposes obligations on the manager vis-a-vis unit holders and vice versa.'

33. It would appear from the above that where the manager of a public unit trust is required to buy-back and/or redeem units on terms set out in the trust deed, whether at the request of the unit holder or upon the determination of the trust, the obligation is contractual in nature.

34. In the Explanatory Memorandum the kinds of contracts intended to be brought within paragraph (d) of the definition of 'security' are discussed at page 59:

> '... paragraph (d) ensures that other terms of contractual arrangements whereby one person is required to pay an amount or amounts to another come within the term "security". It is equally possible for a deferral of income to occur under contractual arrangements as it is under a security arrangement.'

35. It is clear that payments under the kind of contracts there envisaged were to have the character of income. Accordingly we do not accept that paragraph (d) brings within the definition of 'security' amounts paid under contractual arrangements that are not otherwise income according to ordinary concepts and usages.

36. The redemption of units by a manager is the return of some or all of the capital invested in purchasing the unit. The actual payment made by the manager is not an income receipt in the hands of the unit holder. If a net profit or loss arises upon redemption, that net profit or loss will have a capital or income character depending on the circumstances of the taxpayer.

37. Whilst a net profit that is income may arise upon a redemption, it does not necessarily follow that the contract giving rise to the payment which results in that net profit should be brought within Division 16E.

38. Units in ordinary public unit trusts are, therefore, not considered to be within either paragraph (a) or (d) the definition of 'security' in subsection 159GP(1). Accordingly, a unit in such a trust cannot be

traditional security. That it not to say, however, that units reflecting certain kinds of contractual arrangements embodied within a unit trust may never be a security within the meaning of that term in subsection 159GP(1).

Does a guarantee create a 'traditional security' in the hands of the guarantor?

39. This question arises when a taxpayer guarantees the debt of another person. The contract between the guarantor and the creditor creates a corresponding obligation on the principal debtor to indemnify the guarantor. The obligation of the debtor has been said to create a traditional security in the hands of the guarantor.

40. A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or miscarriage of another person whose primary liability to the promisee must exist or be contemplated. In most jurisdictions it is required by statute that the contract must either be in writing or evidenced by a written note or memorandum signed by or on behalf of the party to be charged. The guarantor or surety is the person who engages with the creditor of a third party to be answerable in the second degree for the liability of the third party. See generally *Halsbury's Laws of England*, 4th Edition, Volume 20, paragraphs 101-106.

41. *Chitty on Contracts,* 26th Edition, 1989, Sweet & Maxwell states (at paragraph 5065):

> 'A surety who has actually met the liability which he has undertaken to answer for is entitled to be indemnified by the principal debtor... Where the surety has undertaken his liability at the request, expressed or implied, of the debtor this right may be said to arise in one of two ways; that is, either from an implied actual contract between surety and debtor, or it may be said to be a restitutionary remedy arising from the fact that the surety has been compelled by law to discharge a debt for which the debtor is ultimately liable.'

42. The implied actual contract is entered into at the time the guarantor gives the guarantee to the creditor: *Re A Debtor* (No. 627 of 1936) 1937 1 All ER 1. The Court of Appeal also confirmed a long line of authority supporting the proposition that the debt due to the guarantor by the debtor under the implied contract does not arise until the guarantor has been called upon to pay the creditor under the guarantee. Greene LJ said (at p. 8):

> 'The implied undertaking to indemnify is an undertaking to re-imburse the guarantor upon the happening of a contingency

viz., payment by the guarantor to the creditor, and until that contingency happens, there is no debt.'

43. For the 'implied actual contract' to be a traditional security it would first have to be a 'security' as defined in subsection 159GP(1) of the Act. Again, as for a unit in a trust, it can only be so under paragraphs (a) or (d) of that definition.

44. For the same reasons adopted in paragraphs 29-30 above in relation to units in a trust, we do not accept that a guarantor who has the benefit of a debtor's 'implied actual contract' has a contractual right that satisfies the term 'or other security' in paragraph (a) of the definition of security. The same result follows in respect of the restitutionary remedy that also arises.

45. In respect of paragraph (d) of the definition of security, again, using similar reasoning as in paragraph 37 above relating to units in a trust, we do not think that indemnity contracts of this kind are the sort of contracts intended to be covered by paragraph (d). That is to say, they are not contracts that give rise to a deferral of income in the required sense. The restitutionary remedy that arises when the debt is paid by the guarantor is not founded in contract and, again, the terms of paragraph (d) cannot be satisfied.

Disposal: debt forgiveness

46. Subsection 70B(2) provides that where 'a taxpayer disposes of a traditional security ... the amount of any loss on the disposal...is allowable as a deduction from the assessable income of the taxpayer of the year of income in which the disposal...takes place'.

47. We have been asked whether, prior to 1 July 1992, a traditional security can be disposed of by forgiving or waiving the debt of the issuer of the security.

48. The word 'dispose' is defined in subsection 26BB(1) as follows:

> ' **"dispose"**, in relation to a security, means sell, transfer, assign or dispose of in any way the security or the right to receive payment of the amount or amounts payable under the security;'

49. When a debt is forgiven the liability of the debtor to the creditor is extinguished. When a debt is sold, transferred or assigned the debtor's liability does not cease to exist. Accordingly, for the act of forgiveness to satisfy the definition of 'dispose' in subsection 26BB(1) it would have to fall within the phrase 'dispose of in any way' within that definition.

50. In *F C of T v. Wade* (1951) 84 CLR 105 Dixon and Fullagar JJ, when considering the term 'disposed of' in the former section 36 of the Act, said (at p. 110):

> 'The words "disposed of" are not words possessing a legal technical meaning, although they are frequently used in legal instruments. Speaking generally, they cover all forms of alienation.'

51. In *Henty House Pty Ltd (In Voluntary Liquidation) v. F C of T* (1953) 88 CLR 141 Williams ACJ, Webb, Kitto and Taylor JJ said (at p. 152):

> '...the words "is disposed of" are wide enough to cover all forms of alienation ... and they should be understood as meaning no less than "becomes alienated from the taxpayer", whether it is by him or by another that the act of alienation is done.'

52. We consider that forgiving a debt that is a traditional security was sufficient, prior to 1 July 1992, to dispose of the security or the right to receive payment of the amount or amounts payable under the security.

53. However, the question still remains as to what it takes to forgive a debt? In *Hall v. Commissioners of Inland Revenue* (1926) 11 TC 24 the Court of Appeal held that company resolutions purporting to cancel repayment obligations on loans previously made to its directors were ineffective to cancel the indebtedness of the directors. Scrutton LJ said (at p. 44):

> 'It is clear that you simply cannot release a debt by saying: "I forgive you". It is not a legal transaction. You must get consideration for the release, or some legal formality which implies consideration, such as a release under seal, or you may do it with accord and satisfaction, which also involves consideration.'

54. In *Campbell v. Inland Revenue Commissioner (N.Z.)* 10 A.I.T.R. 444, McGregor J accepted that a deed of forgiveness executed by a company in respect of part of a debt owed to it by certain shareholders was sufficient to release the shareholders from their obligations.

55. In *Case W115*, 89 ATC 899; Case5406 20ATR 4063 a company, *inter alia*, had resolved that a loan from the company to a shareholder be forgiven and that the debt be written off. The Administrative Appeals Tribunal (Senior Member, Mr. Roach) stated (at ATC p.913; ATR p.4078):

> 'Upon the evidence presented before me the resolution to "forgo" and the action taken on the part of (the company) in writing up

> its books of account to give effect to that resolution constituted nothing more than a unilateral act on the part of (the company) whereby the company declared its intention to remit the debt due to it by (the taxpayer) and adopted accounts intended to reflect that decision ... it was not done in such a way as to confer any right upon (the taxpayer) against the company such as would have entitled him to resist a claim for payment of the debt. There is no basis in the evidence before me for (the taxpayer) to contend that he was released, whether by deed under seal or by any agreement for which consideration was given, or that he so acted in consequence of the company's representations as to be entitled to allege an estoppel ... His liability to the company remains as it was ...'

56. In view of the above authorities we have concluded that a creditor can only effectively forgive or waive a debt if the forgiveness or waiver is undertaken by way of a formally executed deed, under an agreement for which consideration was given or in circumstances where the debtor is entitled to allege an estoppel. Where this has occurred prior to 1 July 1992 in relation to a debt that is a traditional security, we accept that there has been a disposal of that security for the purposes of section 70B of the Act. A company resolution, with or without a corresponding write-off in its books of account, is not sufficient to constitute the disposal of a traditional security.

57. From 1 July 1992, the release or waiver of a debt will not constitute the disposal of a traditional security for the purposes of section 70B: see subsection 70B(5).

Disposal: company liquidation

58. Subsection 70B(2) allows a deduction for any loss on the disposal or redemption of a traditional security. When a traditional security matures and the issuer honours the obligation to pay the promised amount, the security may be said to have been redeemed by the issuer.

59. In some cases the issuer may not be able to redeem its securities at the time they mature. This may occur where, for example, the issuer is a company and is insolvent at the time the securities mature. If an insolvent company is being, or has been wound up and the liquidator has made a **final** payment to the holders of traditional securities issued by the company we will accept that the securities have been disposed of at that time.

60. Alternatively, if there is to be no distribution and the liquidator officially notifies holders that this is the case, we will accept that the

official notification constitutes a disposal of the security for the purposes of section 70B.

Disposal: death of the holder

61. On the death of a taxpayer, the property of the deceased taxpayer passes to his or her estate, legal control over which is exercised by an executor or administrator. The executor or administrator, in effect, steps into the shoes of the deceased and winds up the deceased's personal affairs. An executor of a deceased person who leaves a will must obtain probate of the will. This is the official proving of the will and provides the executor with authority to deal with the estate. When probate has been granted, the executor is free to call up the deceased's assets and liabilities, and pay the debts, funeral and testamentary expenses. After these matters have been attended to, the executor distributes the property of the deceased to the beneficiaries of the estate.

62. A traditional security held by a taxpayer at the time of the taxpayer's death will not be taken to have been disposed of by the deceased at that time. If the executor subsequently disposes of the security otherwise than by transferring the security to a beneficiary of the deceased estate, or the security is redeemed, a disposal of the security will have occurred for the purposes of section 26BB and section 70B. Any gain or loss on the disposal or redemption of the security will be the difference between the consideration given by the deceased taxpayer for the acquisition of the security and the consideration received by the executor in respect of the disposal or redemption.

63. A beneficiary will be taken to have acquired a traditional security received by way of a distribution from a deceased estate. We take the view that the consideration for the acquisition is the same as the consideration originally given for the acquisition of the security by the deceased. Any subsequent gain or loss arising upon the disposal or redemption of the security will be assessable or deductible to the beneficiary in the normal way.

Subsection 159GP(2)

64. If subsection 159GP(2) were to apply because of a non-arm's length transaction in relation to the issue of a security, then what might otherwise be a traditional security may become a qualifying security for the purposes of Division 16E. However, it could be expected that except in the most unusual cases, the Commissioner will exercise the discretion given in paragraph 159GP(2)(b) and decide that subsection 159GP(2) should not apply in relation to the issue of what would otherwise be a traditional security.

How does section 70B(3) operate?

65. Subsection 70B(3) provides, broadly, that where the Commissioner is satisfied that the parties to a transaction whereby a traditional security is acquired or disposed of are not dealing with each other at arm's length in relation to the transaction, the consideration for the transaction shall be taken to be an arm's length amount.

66. The term 'dealing with each other at arm's length' was considered by Davies J in *Barnsdall v F C of T* 88 ATC 4565; 19 ATR 1352. The case concerned an assessment that, *inter alia,* included in the assessable income under section 26AAA of the Act a deemed profit arising on the disposition of shares by the taxpayer to a private company controlled by the taxpayer. Subsection 26AAA(4) provides that if property is sold for a greater or lesser amount than its value the consideration is deemed to be its actual value. The subsection can only operate if the Commissioner is satisfied that the taxpayer and the person to whom the property is sold 'were not dealing with each other at arm's length'. At ATC p.4568; ATR p.1355 Davies J said:

> '...sec 26AAA(4) used the expression "not dealing with each other at arm's length". That term should not be read as if the words "dealing with" were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.'

67. In *The Trustee for the Estate of the late AW Furse No 5 Will Trust v. F C of T* 91 ATC 4007; 21 ATR 1123, Hill J, when considering whether parties were dealing with each other at arm's length, said (at ATC p.4015; ATR p.1132):

> 'What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome is a matter of real bargaining.'

68. Once the conclusion is reached that the parties to a transaction were not dealing with each other in relation to the transaction as arm's length parties would normally do, subsection 70B(3) provides that for the purposes of determining the amount deductible under subsection 70B(2) the consideration for the transaction shall be taken to be:

> '(a) the amount that might reasonably be expected for the transaction if the parties were independent parties dealing at arm's length with each other; or

(b) where, for any reason it is not possible or practicable for the Commissioner to ascertain that amount - such amount as the Commissioner determines.'

69. So, for example, if a taxpayer lends money to another person and that loan is a traditional security, the taxpayer has acquired a security for the purposes of sections 26BB and 70B. The consideration for the acquisition is the amount of the loan. If the loan is not repaid and the debt due to the lender is forgiven before 1 July 1992, a loss in respect of that disposal may be deductible under section 70B. However, if the Commissioner is satisfied that the parties to the transaction were not dealing with each other at arm's length in relation to the acquisition or disposal transaction the Commissioner may substitute an arm's length consideration in respect of the acquisition or disposal.

70. In determining an arm's length consideration the Commissioner will use a discounted cash flow analysis where there is no established market from which an arm's length value can be determined.

71. The price or value of a security is normally determined by the time value of money, the risk associated with the transaction and the length of time the lender will be without the use of the money. Where a loan carries a rate of interest which reflects the risk associated with the arrangement (i.e., a true commercial rate) and the principal is repayable at the end of the term, the arm's length consideration for the transaction is the face value of the loan. However, where a loan carries an interest rate which is less than a true commercial rate, the arm's length consideration in respect of the acquisition of the security will be some amount less than the face value of the loan.

72. Calculating an arm's length consideration for the acquisition or disposal transaction requires ascertaining both the period of the loan and an appropriate rate to discount the cash flows under the security. If the loan is 'at call' the likely period of the loan can only be determined from the facts surrounding the particular case. An appropriate discount rate is determined taking into account the time value of money and adding a premium for the risk associated with the transaction. However, given the administrative and technical difficulty of undertaking a risk analysis of each transaction that will come under consideration, benchmark interest rates will be used. Depending on the taxpayer this could be the rate charged on an unsecured personal loan, a business loan, the prime corporate lending rate or some other appropriate benchmark rate.

73. There may be some arrangements within corporate groups that are not subject to a formal contract setting out the terms and conditions of the arrangement e.g., where money is transferred from one entity to another for no set period with minimal documentation or where an entity pays the debt of an associated entity . Without more it

is difficult to construe such arrangements as securities for the purposes of subsection 159GP(1).

74. Examples illustrating the application of subsection 70B(3) commence at paragraph 105.

Part IVA

75. Notwithstanding the potential application of subsection 70B(3) in cases where there has been a non-arm's length disposal of a traditional security, Part IVA of the Act may apply to deny a deduction under section 70B.

76. Broadly speaking, Part IVA applies where a taxpayer obtains a tax benefit in connection with a scheme to which the Part applies. The Part applies if, from an objective view of a scheme and its surrounding circumstances, it would be concluded that it was entered into for the sole or dominant purpose of obtaining a tax benefit.

77. Careful scrutiny of section 70B claims in respect of debt forgiveness arrangements within company groups will be undertaken to determine whether Part IVA of the Act applies to those arrangements.

78. The disposal to an associate for a nominal consideration of a worthless or near worthless traditional security that was acquired at an arm's length price will not necessarily attract the application of Part IVA. For example, Taxation Ruling IT 2643 sets out a number of tests in relation to the transfer to an associate of shares in a company in liquidation that, if satisfied, will not attract the operation of Part IVA. If a traditional security was transferred to an associate under similar circumstances it could be expected that the disposal will not attract the application of the Part. The relevant tests are:

(a) absolute control and ownership of the security is validly and effectively transferred;

(b) the security is transferred at a true market value; and

(c) there is no intention, arrangement or understanding at the time of transfer that the security is to be re-acquired.

The amount of gain on disposal: incidental costs

79. Subsection 26BB(2) provides that the amount of any gain on the disposal or redemption of a traditional security shall be included in the assessable income. We have been asked whether incidental costs associated with the acquisition and disposal of the security can be taken into account when calculating the gain derived.

80. Having regard to the language used we think that subsection 26BB(2) includes in the assessable income the difference between the consideration for the acquisition of the security and the consideration received on the disposal or redemption of the security i.e., incidental costs may not be taken into account in ascertaining any gain or loss. However costs associated with acquiring or disposing of the security, which otherwise satisfy the requirements of subsection 51(1), are deductible under that subsection..

Consideration on disposal or redemption: payment in the form of shares

81. If a taxpayer disposes of a traditional security or a traditional security is redeemed and the consideration received consists of shares in the issued capital of a company, it is necessary to determine the value of that consideration.

82. Section 21 of the Act provides:

> 'where, upon any transaction, any consideration is paid or given otherwise than in cash, the money value of that consideration shall, for the purposes of this Act, be deemed to have been paid or given.'

83. We think that the money value of shares in these circumstances is the same as the market value of the shares: *Case 88* 13 CTBR (NS) 571. The par value or paid up value of the shares is not necessarily their money value and calculations using these amounts do not satisfy the terms of section 21 of the Act.

Issuer of a security: redemption at less than the issue price

84. It has been suggested that subsection 26BB(2) applies to any gain made by the issuer of a traditional security upon the redemption of the security for less than its issue price.

85. We do not agree with that proposition. The first part of the definition of 'traditional security' provides:

> ' **"traditional security"**, in relation to *a taxpayer*, means a security *held by the taxpayer* that:
>
> (a) is or was *acquired by the taxpayer* after 10 May 1989;...'(emphasis added)

Accordingly, we do not think that the taxpayer holding or acquiring a traditional security in the required sense can be the taxpayer who issued the security.

86. Moreover, the 'taxpayer' first mentioned in subsection 26BB(2) is the holder of the traditional security immediately before the 'disposal'. The second-mentioned 'taxpayer' in the subsection, in relation to the redemption of a security, is also the holder of the security immediately prior to the redemption.

87. Accordingly, there is no warrant for reading the subsection as applying to the issuer of a traditional security. Subsection 26BB(2) does not, therefore, include in the assessable income any 'gain' realised by the issuer of a traditional security upon redemption of that security because the security is redeemed for less than its issue price. Similarly, any 'loss' made by the issuer of a traditional security when redeeming the security is not deductible under section 70B.

88. The above conclusions in relation to sections 26BB and 70B do not mean that in appropriate circumstances gains and losses of a revenue nature experienced by the issuer of a traditional security will not be assessable under subsection 25(1) or deductible under subsection 51(1) as the case may be. For example, in *Mutual Acceptance Ltd. v. F C of T* 84 ATC 4831; 15 ATR 1238 the gain made by a finance company representing the difference between the issue price of debentures and the amount at which they were redeemed was held to be assessable income. See also the discussion by McHugh J in *Coles Myer Finance v. F C of T* 93 ATC 4214 at p. 4231; 25 ATR 95 at p. 117.

When is a 'deposit' acquired?

89. The definition of 'security' in subsection 159GP(1) provides that a security includes:

> '(b) a deposit with a bank, building society or other financial institution;'.

90. For a deposit to be a traditional security it has to be acquired after 10 May 1989. The term 'acquire' is defined in subsection 26BB(1):

> ' "**acquire**", in relation to a security, means acquire, on issue, purchase, transfer, assignment or otherwise, the security or the right to receive payment of the amount or amounts payable under the security'.

91. G.A. Weaver and C.R. Craigie, *The Law Relating To Banker and Customer in Australia,* 1990, Law Book Company, describe interest bearing deposits (at para. 3.600) in the following terms:

> 'In Australia banks accept interest bearing deposits for fixed terms and at call ... Deposits for fixed terms are called term deposits, fixed deposits, or interest bearing deposits ... under the

> Australian system the conditions on which the deposit is accepted are either embodied in a receipt, or can be determined by reading together both the customer's written request to the bank to accept the deposit and the receipt. Thus there is a separate receipt and a separate contract for each deposit.'

92. In view of the above we think that each fixed deposit, being a separate contract, is a paragraph (b) security for the purposes of the definition in subsection 159GP(1). Accordingly, a customer who makes a fixed deposit with a financial institution has 'acquired' a security at the time of making the contract.

Is a current account a security?

93. Weaver and Craigie (supra) describe a current account as follows (at para. 7.40):

> 'Current is used here in the sense of flowing or running, like a stream...the moneys paid to the bank for credit of the customer's account form one incoming stream, while an outgoing stream of payments is made by the bank at the customer's direction ... After payment to the bank all these moneys become one single fund at the disposal of the customer.'

94. It can be seen from the above that a deposit with a bank (i.e., a fixed deposit) is different to an account with a bank (i.e., a current account or a savings account) whether interest bearing or not. The records of term deposits in a bank's books are not strictly accounts in the conventional sense because the customer does not operate on them. This is unlike a savings account which is able to be operated on by the customer in the same way as a current account.

95. Notwithstanding the above, we accept that an account with a bank can be a traditional security given that a debtor/creditor relationship exists between the bank and the customer. In this sense it does not matter whether the debt is in respect of the amount on deposit or the amount standing to the credit of the account. The nature of the relationship is not altered by an agreement by the banker to allow interest on the balance in the account: *Foley v. Hill* [1843-60] All ER 16.

96. Like a fixed deposit, we think that a traditional security, being the debt owing from the bank on a current or savings account with an institution is acquired when the account is opened i.e., when the contract between the banker and customer is entered into.

97. The amount of the debt owed to the customer in respect of a current or savings account at any particular time is the balance of the account. The balance of the account is one and indivisible and the

customer's right to withdraw the credit balance is a single, not a composite, chose in action: *Alcom v Republic of Colombia* [1984] AC 580.

98. Weaver and Craigie (ibid.) describe the English 'deposit account' as thus:

> 'In England some deposits are accepted for fixed terms but a more usual arrangement in that country is for a deposit account on which interest is calculated on a day to day basis, and to which the customer can deposit further moneys from time to time. Withdrawals can be made either of the whole or part of the balance on giving a fixed period of notice; 14 days notice is quite usual. The English Court of Appeal has held (*Hart v. Sangster* [1957] Ch 329) that for such an account there is one continuing contract. No doubt the same would apply if a comparable system were to be adopted in Australia.'

99. In *Hart v. Sangster* Lord Goddard CJ was seemingly of the view that in many respects there was no difference between a deposit account and a current account (see [1957] 2 All ER 208 at p. 210). From the point of view of whether both kinds of accounts were one continuing contract there is no apparent difference. In *N. Joachimson (A Firm Name) v. Swiss Bank Corp.* [1921] All ER 92, Atkin LJ when discussing the characteristics of a current account said (at p.100):

> 'I think there is only one contract made between the bank and its customer.'

100. Whilst a bank borrows money from a customer under terms to repay it, the credit balance in a current account does not become due and payable until the customer demands payment of it: *N. Joachimson v. Swiss Bank Corp.* (supra). The position is that there is an implied obligation on the part of the customer to make an actual demand for the amount standing to his credit on current account as a condition precedent to a right to sue for that amount.

101. In this respect Bankes LJ said (at p. 96):

> 'Unless this were so, the banker, like any ordinary debtor, must seek out his creditor and repay him his loan immediately it becomes due - that is to say, directly after the customer has paid the money into his account - and the customer, like any ordinary creditor, can demand repayment of the loan by his debtor at any time and any place.'

102. Notwithstanding that the right to sue for the account balance only arises once a demand has not been satisfied, the security, i.e., the debt owing from the bank, is acquired under the contract entered into when the account is opened. That is to say, an account holder acquires the security, being the debt that arises under the contract entered into,

when the account is opened and not when subsequent deposits are made to the account.

103. In cases involving an inter-company loan that may involve more than one draw-down, the same approach should be taken. As with a bank account, the lender acquires a security when the contract establishing the loan is entered into.

Penalties and Interest

104. Our policy in relation to penalties and interest on understatements of tax in respect of tax returns for the 1991-92 income year where an amendment is made after 30 June 1992 are set out in Taxation Ruling TR 92/10. Broadly, the principles of the self assessment penalty legislation and changes to the section 170AA rate of interest are to apply. The principles contained in Taxation Ruling IT 2517 will apply to income tax returns for income years prior to 1991-92.

Examples

Example 1

105. A taxpayer lent $16,000 to a private company which the taxpayer controlled. The loan was made after 10 May 1989. The loan was unsecured, repayable at call and carried no interest rights. The company was experiencing liquidity problems and trading prospects in the short term were not good. Subsequently the company was placed in liquidation and wound up. The taxpayer did not receive any distribution on winding up.

106. The winding up of the company constitutes a disposal of the security. The parties were dealing with each other at arm's length in respect of the disposal. However, in respect of the acquisition by the taxpayer of the security, we contend that the parties were not dealing with each other at arm's length.

107. The relevant enquiry is: what would a party dealing at arm's length pay for the debt due to the taxpayer immediately after the loan was made? In such circumstances it is necessary to determine when it was reasonably likely that the loan would be repaid as well as an appropriate discount rate. Assume the taxpayer could demonstrate that at the time the loan was made it was reasonable to assume that the loan would be repaid after 5 years. The appropriate benchmark rate for unsecured loans at that time was 17%. The arm's length consideration for the acquisition of the security (ignoring any premium for risk) is the sum of the present values of all the payments to be

made under the security. As the loan does not carry interest the only receipt will be the repayment of the principal. Accordingly, only one present value calculation needs to be performed:

Arm's length consideration: = $\frac{\text{Face Value of Loan}}{(1 + r)^n}$

where r = interest rate

n = number of years

$$= \frac{16{,}000}{(1 + 0.17)^5}$$

$$= \$7{,}298$$

The loss on disposal allowable under subsection 70B(2) is the arm's length consideration for the acquisition ($7298) less the amount received on disposal (nil) i.e., $7298.

Example 2

108. On 1 August 1989 a company lent $100,000 to a subsidiary for 5 years at 10% interest per annum. The commercial rate of interest at that time was 16% per annum. The subsidiary subsequently experienced cash flow difficulties but continued to trade and was expected to be successful in the long term. The parent company executed a deed of forgiveness in respect of the debt on 1 August 1991 and has claimed a deduction under section 70B of $100,000. At the time of the debt forgiveness the appropriate benchmark rate of interest was 20%.

109. As in Example 1 we would not accept that the transaction by which the security was acquired was an arm's length dealing. A commercial interest rate was not payable on the loan. Whilst there has been an effective disposal of the debt, the disposal transaction will also not be accepted as an arm's length dealing. Although the subsidiary was experiencing cash flow difficulties, it continued to trade and was expected to be successful in the long term. It is unlikely that an arm's length party would dispose of the right to receive the amounts payable under the loan for no consideration.

110. Calculating an amount for the purposes of paragraph 70B(3)(a) in respect of the consideration for the acquisition of the security should be on the same basis as the calculation in Example 1 above. The consideration in respect of the disposal transaction should be

calculated by discounting the future cash flows under the loan using the appropriate benchmark rate of interest at the time the debt was forgiven.

Acquisition price (at 1/8/89):

Payment Date	1/8/90	1/8/91	1/8/92	1/8/93	1/8/94
Cash flow	10,000	10,000	10,000	10,000	110,000
divided by					
Discount factor	$(1+16\%)^1$	$(1+16\%)^2$	$(1+16\%)^3$	$(1+16\%)^4$	$(1+16\%)^5$
Present Values	8,621	7,432	6,407	5,523	52,372
Net Present Value	80,354				

Disposal price (at 1/8/91):

Payment Date	1/8/92	1/8/93	1/8/94
Cash flow	10,000	10,000	110,000
divided by			
Discount factor	$(1+20\%)^1$	$(1+20\%)^2$	$(1+20\%)^3$
Present Values	8,333	6,944	63,657
Net Present Value	78,935		

70B(2) amount:

Arm's length disposal cost	78,935
less	
Arm's length acquisition cost	80,354
equals	
Traditional security loss	(1,419)

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