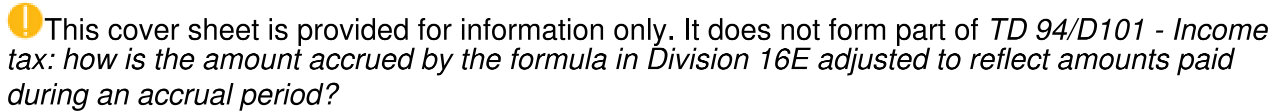
TD 94/D101 - Income tax: how is the amount accrued by the formula in Division 16E adjusted to reflect amounts paid during an accrual period?



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Draft Taxation Determination

Income tax: how is the amount accrued by the formula in Division 16E adjusted to reflect amounts paid during an accrual period?

1. Division 16E of Part III of the *Income Tax Assessment Act 1936* was enacted to prevent tax deferral opportunities which were available from certain discounted and deferred interest securities. Under Division 16E, the income and deductions from these securities are spread over the term of the security on a basis which reflects the economic gains and losses which have accrued at any point in time.

2. Division 16E applies to a class of securities defined as 'qualifying securities'. Qualifying securities are divided into two groups: 'fixed return securities' and 'variable return securities'. Assessable income and allowable deductions under qualifying securities are brought to account on a six monthly compounding accruals basis.

3. For all qualifying securities issued after 27 January 1994, the assessable or deductible amounts are the accrual amounts calculated under section 159GQB for each accrual period (six months or a portion of six months) in the term of the security. This calculation includes an adjustment to reflect payments made under the security other than at the end of the relevant accrual period. (A similar adjustment is required for fixed return securities issued before 28 January 1994.)

4. The Explanatory Memorandum to *Taxation Laws Amendment Act (No 2) 1994* contained an example of the calculation of a proper adjustment to reflect payments made other than at the end of an accrual period (Example 4, Chapter 2). The formula in that example is incorrect. The correct formula is:

$$\text{Payment} \times [(1 + \text{'implicit interest rate'})^{(\text{time left in accrual period after payment made/accrual period})} - 1]$$

Applying the correct formula to the facts of that example (set out below) results in an adjustment amount of $12.35:

Length of accrual period: 6 months
Implicit interest rate: 5% (per six monthly interval)
Assume that a payment of $500 is made 3 months into the accrual period.

$$\$500 \times [(1 + 5\%)^{(3 \text{ months}/6 \text{ months})} - 1]$$

$$\Rightarrow \quad \$500 \times .024695 = \$12.3475 \approx \$12.35$$

Example

A payment of $1,000 is made 2 months into a 6 month accrual period. That is, there are 4 months left in the accrual period when the payment is made. If the implicit interest rate for the accrual period is 4%, the required adjustment is:

$$\text{Payment} \times [(1 + \text{'implicit interest rate'})^{(\text{time left in accrual period after payment made/accrual period})} - 1]$$

$$\Rightarrow \quad \$1,000 \times [(1 + 4\%)^{(4\ \text{months}/6\ \text{months})} - 1]$$

$$\Rightarrow \quad \$1,000 \times .026492 = \$26.492 \approx \underline{\mathbf{\$26.49}}$$

Commissioner of Taxation
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