

GSTR 2006/1 - Goods and services tax: guarantees and indemnities

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Goods and Services Tax Ruling

Goods and services tax: guarantees and indemnities

Contents	Para
What this Ruling is about	1
Date of effect	4
Frequently used terms	6
Background	20
Ruling and Explanation	48
Detailed contents list	140

Preamble

*This document is a ruling for the purposes of section 37 of the **Taxation Administration Act 1953**. You can rely on the information presented in this document which provides advice on the operation of the GST system.*

What this Ruling is about

1. This Ruling explains how guarantees and indemnities are treated under the GST legislation. To do this, the Ruling explains the meaning and application of item 7 in the table to subregulation 40-5.09(3) (item 7) of the *A New Tax System (Goods and Services Tax) Regulations 1999* (the GST regulations).
2. In particular, this Ruling describes the different kinds of guarantees and indemnities, and distinguishes between contracts and rights commonly known as guarantees or indemnities that do not fall within item 7, and those contracts and rights that do.
3. The Ruling also identifies the supplies that take place under typical guarantees and indemnities, and classifies them into those arrangements that may be taxable supplies and those arrangements that may be financial supplies, and therefore potentially input taxed supplies.

Date of effect

4. This Ruling explains the Commissioner's view of the law as it applied from 1 July 2000. You can rely upon this Ruling on and from its date of issue for the purposes of section 37 of the *Taxation Administration Act 1953*. Goods and Services Tax Ruling GSTR 1999/1 explains the GST rulings system and the Commissioner's view of when you can rely on our interpretation of the law in GST public and private rulings.

5. If this Ruling conflicts with a previous private ruling that you have obtained, this public ruling prevails. However, if you have relied on a private ruling, you are protected in respect of what you have done up to the date of issue of this public ruling. This means that if you have underpaid an amount of GST, you are not liable for the shortfall prior to the date of issue of this later ruling. Similarly, you are not liable to repay an amount overpaid by the Commissioner as a refund.

Frequently used terms

'Guarantee' and 'indemnity'

6. This Ruling deals with guarantees and indemnities. It uses common legal concepts of both these terms to explain how GST applies to them. Both terms, however, can have a number of meanings in commercial and legal contexts, and must, therefore, be defined with care. This section explains these terms, and some related terms, and how they are used in this Ruling.

7. The guarantee and indemnity arrangements covered by item 7 have characteristics in common: they all involve three parties, and underlying indemnities flow from the relationships between the parties. The nature of the risk undertaken by the surety in these arrangements is a form of credit risk. In this Ruling 'credit risk' means the risk that the principal will be unable to reimburse the surety if the surety is required to make a payment.

8. To determine whether an interest is covered by item 7, it is not necessary to distinguish between a guarantee and an indemnity. Where an arrangement has the characteristics referred to above (and in paragraphs 48 to 52) it is covered by item 7, regardless of whether, on closer legal analysis, it is a guarantee or an indemnity.

Terms for the parties to a guarantee or indemnity arrangement

9. The three parties involved in guarantees and indemnities covered by item 7 are known by a number of different names in commercial practice.

10. The party who wishes, for example, to borrow money, receive services on credit, or enter into some other arrangement under which there is some form of credit risk, is often known as the:

- debtor;
- principal debtor;
- principal; or
- obligor.

11. In this Ruling, for simplicity and consistency, this party in a guarantee or an indemnity is referred to as the 'principal'.

12. The party who has the risk, and who requires the guarantee or indemnity, is often known as the:

- creditor; or
- obligee.

13. In this Ruling, this party is referred to as the 'creditor' despite the fact that there is not always a debtor-creditor relationship with the principal.

14. Lastly, there is the person who guarantees or indemnifies the creditor against loss. This person is often known as the:

- guarantor;
- surety; or
- indemnifier.

15. In this Ruling, this party is called the 'surety'. To assist readers to understand the analysis, the term 'surety' has been used consistently throughout the Ruling, even though an indemnifier is not technically a surety. 'Surety under a guarantee', or 'surety under an indemnity' is specified where necessary.

16. For example, therefore, in a simple guarantee for a bank loan, the borrower is referred to as the principal, the bank is referred to as the creditor, and the person who stands as guarantor is referred to as the surety.

Terms used for parties to a guarantee of performance under a contract of service

17. Different terms are used for the parties to contracts that guarantee the performance of services. If a guarantee is given that certain work will be done, or services performed, the following terms are used: the 'service provider' is the party whose services are guaranteed; the 'recipient' is the party who receives the services and the benefit of the guarantee; and the 'surety' is the party giving the guarantee.

18. Thus, in a simple guarantee of the performance of building work where a bank guarantees the work of a contractor for a land owner: the contractor is the service provider; the land owner is the recipient; and the bank is the surety.

Deeds of guarantee

19. For simplicity, this Ruling refers to guarantees as *contracts of guarantee*, whether the guarantees are created for consideration or by deed, and whether written or unwritten.

Background

Guarantees and indemnities in GST

20. Under section 40-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act), financial supplies are input taxed. The term *financial supplies* is defined in the GST regulations under Subdivision 40-A.

21. The table in sub-regulation 40-5.09(3) lists the interests which can be financial supplies when they are provided, acquired, or disposed of. Item 7 in the table lists:

A guarantee, including an indemnity (except a warranty for goods or a contract of insurance or reinsurance).

22. Part 5 of Schedule 7 to the GST regulations gives the following examples of things included under item 7:

1. an indemnity that is not a contract of insurance;
2. a surety bond that is a guarantee; and
3. a performance bond.

23. None of the terms referred to in paragraphs 21 and 22 is defined in the GST Act or GST regulations.

Guarantees and indemnities in general law

24. A guarantee is an agreement under which one entity (the surety) agrees to be liable for the obligations of another (the principal) if the principal defaults. An indemnity is an obligation to an entity (the creditor) assumed by another (the surety), under which the surety agrees to keep the creditor harmless from risks arising from dealings with a third party.¹

25. Under a guarantee, there are two obligations: the primary and secondary obligation. The principal has the primary obligation to the creditor, the surety the secondary. In other words, the surety has no liability under the guarantee unless the principal defaults on the primary obligation.

26. A surety under a guarantee can not have a primary liability, nor can the surety's liability be greater than the principal's liability. If the primary obligation is extinguished, so is the guarantee. An event that alters the surety's liability may also extinguish the guarantee.

27. The nature of the obligation assumed by the surety is the main distinction between a guarantee and an indemnity. In a contract of guarantee, the surety assumes a secondary obligation in case of the principal's default. In an indemnity, the surety assumes a primary obligation from the time the contract is made, whether or not the principal defaults. That is, the creditor can recover directly from the surety under an indemnity, without waiting for default by the principal. The principal, of course, also has a primary liability to the creditor. Unlike the obligation of the surety under a guarantee, the obligation under an indemnity may differ from what would have been the obligation of the principal.

¹ Indemnities can also be contracted against the occurrence of some event, but these indemnities are often in the nature of insurance, and are therefore not covered by item 7. For further discussion on insurance-type indemnities, see paragraphs 38 to 41.

28. The surety under either a guarantee or an indemnity has a right of recovery for losses against the principal. That is, the surety has a right to be indemnified or reimbursed by the principal. This right may be contractual or arise only in equity. This Ruling refers to this as the 'underlying indemnity'.

Statute of Frauds

29. Much of the case law on the character of guarantees concerns the *Statute of Frauds*.² To be enforceable as a guarantee under the Statute, a guarantee must be in writing.

30. The requirements for guarantees under the Statute have been written into most relevant Australian State and Territory legislation, though in New South Wales and the ACT, guarantees need not be in writing to be enforceable.³

31. This body of law is principally concerned with the enforceability of contracts of guarantee. It is clear, however, that a contract of guarantee need not be enforceable under statute to be a 'guarantee'. For the purposes of item 7, therefore, guarantees need not be in writing.

32. Indemnities are not covered by the Statute of Frauds, and need not be in writing for the purposes of item 7.

Warranty

33. The term *warranty* is often used interchangeably with *guarantee* in commercial parlance. The two terms, however, are not equivalent in law, or under the GST legislation. Warranties are legally distinct from guarantees,⁴ and their treatment under the GST law differs. The distinction between a guarantee and a warranty is further discussed at paragraphs 92 to 99.

34. Warranties may exist within broader contracts. Technically, a warranty is a collateral or incidental term of a contract that gives an injured party a right to damages, but not the right to terminate the contract.⁵ In contract law, warranties under contracts are contrasted with *conditions*, which relate to the main purpose of the contract and the breach of which can result in termination.

² *Statute of Frauds 1677* (UK).

³ O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee* (3rd ed), Law Book Company, Sydney, p. 67.

⁴ The two are distinguished in the New Zealand case, *The Commissioner of Inland Revenue v. Motorcorp Holdings Ltd and Ors* [2005] NZCA 33, CA17/04, paragraphs [60] and [61].

⁵ *Halsbury's Laws of England* (4th ed) 9: 543; 18: 1299n.

35. In the context of contracts for the sale of goods, warranties are terms (express or implied) that are collateral to the contract for sale, and which give the purchaser the right to damages if the seller breaches the warranty, but not the right to reject the goods and terminate the contract. A typical example of a warranty in a sale of goods is that the goods will pass to the purchaser in the condition described, and perform their function for a prescribed period.

36. Not everything called a warranty in commercial dealings is a warranty in legal terms. In the commercial world, particularly in retail sales, *warranties* are often contracts in their own right, in which a supplier or manufacturer agrees to repair or replace faulty goods or compensate faulty workmanship where these come to light within an agreed period of time. In some cases, a third party may offer this contractual 'warranty' for goods as an incentive for a purchaser to enter into a contract of sale with another entity or may offer, for a fee, to extend the warranty offered by the supplier. This is discussed further at paragraphs 92 to 99.

37. *Warranty* also has a particular meaning under contracts of insurance.

Insurance

38. A contract of insurance may be classified according to its nature, that is, whether it is one of indemnity or whether it amounts to a contract for the payment of a sum of money on the happening of a contingency.⁶ Indemnity insurance holds the insured harmless against loss. This is the object of the most commonly understood type of insurance.⁷

39. Contracts of insurance can be distinguished from guarantees and other forms of indemnity. Unlike a surety in an item 7 guarantee or indemnity, an insurer has no underlying right to be indemnified by the insured. The insurer bears the full risk of the contract. For this reason, contracts of insurance are contracts *uberrimae fidei* – contracts of 'utmost good faith' – and are therefore conditional on the insured disclosing to the insurer facts relevant to the risk the insurer will bear.

40. Another distinguishing feature of insurance is that it must be effected with a direct, explicit, and independent contract. In a guarantee, the three parties can assume their roles as principal, creditor, and surety under separate agreements which, for the purposes of GST, need not be in writing. Indemnities need not be written and can be recognised in equity rather than contract in some circumstances. Insurance, however, requires a contract. This is usually in response to a signed proposal from the insured. Under the contract, the insurer agrees to pay the insured a sum on the happening of a certain event.

⁶ Sutton, K 1999, *Insurance Law in Australia* (3rd ed), Law Book Company, Sydney, p. 12.

⁷ Contingency insurance, by contrast, is insurance contingent on the occurrence of some event. Loss of income insurance is an example of contingency insurance.

41. Summarising, the distinguishing features of insurance are:
- The insurer has primary liability under the contract;
 - The insurer bears the risk of loss,⁸ that is, the insurer has no right to be indemnified by the insured under the contract;
 - The contract is made in utmost good faith, that is, the insured must disclose anything relevant to the insurer's risk;
 - The insured is not entitled to profit from the contract, that is, if the insured salvages anything from the loss, the amount salvaged is reflected in the settlement by the insurer;
 - The contract is usually made in a commercial context, and the insurer receives a premium;
 - The contract of insurance is usually formed by the insurer issuing a policy in response to a proposal by the insured;
 - A contract of insurance is void if the insured has no insurable interest in the subject matter; and
 - The insurer must be an entity authorised to carry on an insurance business.

Reinsurance

42. Only an insurer can reinsure. Reinsurance is the method insurers use to lay off or cede part or all of their risk under a policy. A reinsurance policy is insurance against an insurer's risk of having to pay out on a policy the insurer has issued. It is, therefore, a form of indemnity and, like other insurance, a contract of utmost good faith between the insurer and reinsurer.

43. An insurer may reinsure with a number of insurers, to spread large risks. If the insured makes a claim upon which the insurer must pay, each reinsurer is only liable for the amount under their policy of reinsurance, not for the whole amount of the insurer's liability under the policy.

44. For there to be reinsurance, there must be an original insurance contract (that is, a contract between insurer and insured, which then becomes the subject of reinsurance by the insurer).

45. Reinsurance has the characteristics of insurance. Like other forms of insurance, reinsurance is not a financial supply. The only exception to this is life insurance, which is a financial supply, as is its reinsurance.

⁸ Except to the extent of any excess the insured must pay on a claim.

46. Paragraphs 103 to 105 discuss the special industry use of the term 'reinsurance' in the context of surety bonds.

Performance bonds

47. In a performance bond, a surety is liable for the performance, by a service provider, of the conditions under the service provider's contract with the recipient of the services.⁹ The surety's obligation is to make good the service provider's obligation. Performance bonds do not usually cover an obligation of the service provider to make payment, but rather an obligation to perform services, or carry out other work, or meet conditions in a contract. A performance bond may take the form of a guarantee (that is, the surety has a secondary liability), but are commonly indemnities (where the surety takes on a primary liability along with the service provider).

Ruling and Explanation

The meaning of item 7: 'guarantee, including an indemnity'

48. Goods and Services Tax Ruling GSTR 2003/16¹⁰ gives some guidance on interpreting the phrase 'guarantee, including an indemnity' in item 7. The Ruling states that item 7 includes only the kinds of indemnities referred to by the High Court in *Sunbird Plaza Pty Ltd v. Maloney (Sunbird Plaza)*.¹¹

49. Paragraphs 74 and 75 of Goods and Services Tax Ruling GSTR 2003/16 say:

74. The expression 'indemnity' takes different meanings according to its context. At its broadest, it is used to refer to an undertaking to hold another harmless against loss. In this broad sense, it may embrace recompense for any loss or liability which one person has incurred, arising out of contract or by operation of law. An example of the latter is a guarantor's right of indemnity from a principal.

75. The High Court in *Sunbird Plaza Pty Ltd v. Maloney (Sunbird Plaza)* has described an indemnity as 'a promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction *with a third party*' (emphasis added). Given its use in Item 7 as part of the expression 'Guarantee including an indemnity' in the context of guarantees and indemnities of the type supplied for consideration, we consider that 'indemnity' is used in Item 7 in the sense articulated by the High Court in *Sunbird Plaza*. Income guarantees are not such indemnities as the harm against which protection is provided does not arise as a consequence of a transaction with a third party.¹²

⁹ See paragraphs 17 and 18 for an explanation of 'service provider' and 'recipient'.

¹⁰ GSTR 2003/16 Goods and services tax: inducements to enter into a lease of commercial premises.

¹¹ *Sunbird Plaza Pty Ltd v. Maloney* (1988) 166 CLR 245; (1988) 77 ALR 205.

¹² GSTR 2003/16 paragraph 75 footnotes *Sunbird Plaza* (1988) 166 CLR 245 at 254; (1988) 77 ALR 205 at 207.

50. The conclusions relating to the nature of guarantees and indemnities in *Sunbird Plaza* are widely supported, both in case law and in legal texts. The comments in *Sunbird Plaza* follow those in earlier cases, both Australian and British,¹³ and are supported strongly in *The Modern Contract of Guarantee*,¹⁴ the text widely regarded as the authority on guarantees and indemnities in Australia.

51. The common characteristics of guarantees and indemnities covered by item 7 are drawn from the law as discussed above. The arrangements (whether guarantees or indemnities) involve three parties and in each arrangement, there is an underlying indemnity which flows from the relationships between the parties.

52. Because of the existence of this underlying indemnity, the nature of the risk undertaken by the surety in these arrangements is the risk that the principal will be unable to reimburse the surety if it is required to make a payment. This risk is a form of credit risk.

Guarantees

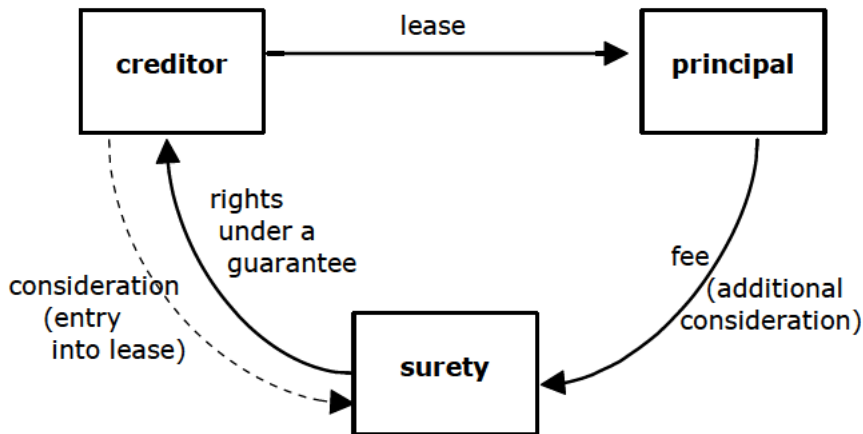
53. There are three parties to a guarantee: the principal, the creditor and the surety. Guarantees are contractual arrangements under which the surety agrees to make good the obligation of the principal if the principal defaults.

54. Guarantees (and indemnities) may be recompensed or non-recompensed. In a recompensed guarantee, the surety is paid a fee, usually by the principal. Most guarantees provided in a commercial environment are recompensed guarantees. But the form of guarantee under which the directors of a family company guarantee the company's obligations is usually a non-recompensed guarantee.

55. The diagram below sets out the flow of obligations and consideration under a typical recompensed guarantee for lease payments. The creditor supplies a commercial lease to the principal. The principal pays the surety to provide rights under a guarantee to the creditor (a financial supply). The surety, in this case, receives consideration from two sources, the creditor and the principal.

¹³ *Total Oil Products (Aust) v. Robinson* [1970] 1 NSW 701; *Yeoman Credit Ltd v. Latter* [1961] 2 All ER 294.

¹⁴ O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee* (3rd ed), Law Book Company, Sydney, p. 52.

Figure 1: Flow of supplies and consideration under a guarantee**Supply of an interest in a guarantee**

56. Paragraph 12 of Taxation Ruling TR 96/23,¹⁵ which is about the capital gains tax implications of a non-recompensed guarantee to pay a debt, says:

On entering into a guarantee contract, a creditor acquires a further asset (in addition to the underlying debt) being the contractual rights under the guarantee, that is, rights including a right to call on the guarantor for payment.

57. The supply of an interest in a guarantee must be for consideration unless the guarantee is under seal:

The consideration for the guarantee must move from the person to whom the guarantee is given; although indeed the whole consideration need not move from that person. In the context of a guarantee, the consideration will be in the form of a creditor incurring some detriment in reliance on the promise to guarantee rather than conferring some benefit upon the guarantor.¹⁶

¹⁵ TR 96/23 Income tax: capital gains: implications of a guarantee to pay a debt.

¹⁶ O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee* (3rd ed), Law Book Company, Sydney, p. 52.

58. The consideration that the creditor provides is their entry into the arrangement with the principal: for example, the entry into a lease. This view follows that given in Taxation Ruling TR 96/23 at paragraph 59 to 60, which itself cites the second edition of *The Modern Contract of Guarantee* and cases to support its view. The third edition of *The Modern Contract of Guarantee* states:¹⁷

The usual form of consideration provided by the creditor is the creditor's action in entering into the principal transaction (for example, by the supply of particular goods;¹⁸ the making of advances to the principal;¹⁹ the entering into a lease²⁰ [...]) In cases in which the consideration is the actual act of entering into the principal transaction, the guarantee will only become binding when that act occurs, that is, by the actual supply of goods, the actual making of advances or the entering into a lease.²¹

59. The surety therefore makes a supply of an interest in a guarantee for consideration. Taxation Ruling TR 96/23 identifies the consideration provided by the creditor as the promise of the creditor to make a loan, or extend or maintain credit to the debtor. The Ruling sets the market value of the consideration provided by the creditor at nil.²²

60. While the entry into the principal transaction is consideration, that consideration is in the form of a detriment to the creditor, rather than a benefit to the surety. The entry into the transaction, therefore, is not, of itself, a supply by the creditor to the surety for the purposes of the GST law.

61. Whether or not the principal pays a fee to the surety, the principal has no rights under the guarantee, and does not acquire an interest in a guarantee for the purposes of item 7. That is, the surety does not make a supply of an interest in a guarantee to the principal. It does, however, make a supply of such an interest to the creditor, as shown in Figure 1.

¹⁷ O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee* (3rd ed), Law Book Company, Sydney, p. 54.

¹⁸ *Raikes v. Todd* (1838) 8 Ad & El 846 at 857; 112 ER 1058 at 1062 per Patterson J, *Robertson v. Healy* (1866) 5 SCR (NSW) 290, *Chapman v. Sutton* (1846) 2 CB 634; 135 ER 1095, *Bank of Montreal v. Germain* [1976] WWD 75

¹⁹ *Smith v. Passmore* (1883) 4 LR (NSW) 274, *SH Lock Discounts & Credits Pty Ltd v. Miles* [1963] VR 656, *Westhead v. Sproson* (1861) 6 H & N 728; 158 ER 301. See also *Mockett v. Ames* (1871) 23 LT 729.

²⁰ *Chan v. Cresdon Pty Ltd* (1989) 168 CLR 242.

²¹ *Greenham Ready Mixed Concrete Ltd v. CAS (Industrial Development) Ltd* (1965) 109 SJ 209 (the consideration was 'recommencing to supply' the principal), *National Australia Bank Ltd v. McKay* [1995] ATPR 41-409 (consideration constituted by provision of 'banking accommodation'), *Hill Equipment & Refrigeration Co Pty Ltd v. Nuco Pty Ltd* (1992) 110 FLR 25; (1992) 10 BCL 375, *Chan v. Cresdon Pty Ltd* (1989) 168 CLR 242, *Bank of Montreal v. Sperling Hotel Co Ltd* (1973) 36 DLR (3d) 130, *Westhead v. Sproson* (1861) 6 H & N 728; 158 ER 301, *Morrell v. Cowan* (1877) 6 Ch D 166 at 170.

²² TR 96/23 paragraph 14.

62. If the principal pays the surety a fee, it is further consideration for the supply of an item 7 interest in a guarantee, that is, in addition to the consideration provided by the creditor.

63. The surety, in creating the interest in the guarantee, makes a supply to the creditor and is therefore the financial supply provider of the interest. If the other conditions of subregulation 40-5.09(1) of the GST regulations are met, the surety makes a financial supply.

64. The creditor, in acquiring the interest, may also make a financial supply.²³

The underlying indemnity

65. In most guarantees, the surety has the right to be indemnified by the principal. This occurs as a matter of course when a surety enters into a guarantee at the request of the principal, or the principal has knowledge of, or concurs with, the granting of the guarantee. As noted at paragraph 30 of Taxation Ruling TR 96/23:

On entering into a contract of guarantee, the guarantor acquires an asset which is a right to be indemnified by the principal debtor. That right of indemnity arises by way of an express or implied term in the contract of guarantee, if the contract is a tri-partite agreement. Otherwise, the right of indemnity arises under an implied contract of indemnity between the principal debtor and the guarantor on entry into the contract of guarantee. Until default by the principal debtor and payment by the guarantor, a guarantor is not entitled to sue on the right of indemnity (whether it is a legal or an equitable right). Of course, the debtor may not default, the debt may be otherwise paid or it may be released.

66. If the principal is not a party to the contract, and neither requested nor was aware of it, the surety's ability to obtain reimbursement relies on a restitutionary claim.

67. The creation of the underlying indemnity in a guarantee, whether it arises under contract or otherwise, is not the provision of an indemnity for the purposes of item 7. The Commissioner considers that the intention of listing a 'guarantee, including an indemnity' in item 7 was to ensure that supplies of interests in guarantees and those indemnities covered by the item would be financial supplies.

²³ Provided the other conditions of subregulation 40-5.09(1) of the GST regulations are met. Given that under subregulation 40-5.06(2) of the GST regulations, the acquirer of a financial interest is also the financial supply *provider* of the interest, it is usual for the acquirer of an interest under subregulation 40-5.09(1) to also be making a financial supply. This is known as the 'acquisition-supply'. For more detail on the acquisition-supply, see GSTR 2002/2 Goods and services tax: GST treatment of financial supplies and related supplies and acquisitions.

68. The Commissioner does not consider that the intention was to require such guarantees and indemnities to be further analysed to expose the underlying indemnities that arise incidentally under those contracts, and treat them as separate supplies. Following this reasoning, these underlying indemnities do not give rise to separate supplies and therefore the incidental creation of such underlying indemnities is not a financial supply.

69. Similarly, not every arrangement involving three parties that results in the creation of an indemnity involves a supply of an indemnity under item 7. For example, there is a requirement arising in law that a principal indemnifies its agent, or a third party that contracted with its agent, if the agent is unwilling or unable to do so. These indemnities are not treated as being separate to the contract under which they arise, in a similar way to the underlying indemnity.

Indemnities

70. An indemnity, for the purposes of item 7, is an arrangement involving three parties. In an indemnity, the surety takes primary responsibility for an obligation arising in relation to a third party. That is, the creditor may recover directly from the surety, regardless of whether the principal defaults.

71. As with guarantees, indemnities may be recompensed or non-recompensed. Under the GST regulations, supplies of interests under an indemnity are treated in the same way as those made under a guarantee.

72. In common with guarantees, the surety under an indemnity to which item 7 applies has a right to be indemnified or reimbursed by the principal. This underlying indemnity may arise either contractually or in equity, depending on whether the principal requested or had knowledge of the granting of the indemnity.

73. As with underlying indemnities arising under guarantees, the incidental creation of underlying indemnities within indemnities is not a financial supply.

Payment under a guarantee or indemnity

74. If the surety is called upon to make a payment to the creditor under a guarantee or indemnity, the payment is made as a result of the exercise of the creditor's rights under the guarantee or indemnity.²⁴

²⁴ For the purposes of capital gains tax, the exercise of the creditor's rights is a disposal of its rights under the guarantee and a CGT C2 event under section 104-25 of the *Income Tax Assessment Act 1997*.

75. Where the surety pays money, this is not consideration for the release of the surety from an obligation under paragraph 9-10(2)(g) of the GST Act, nor is it consideration for the surrender of the creditor's rights under paragraph 9-10(2)(e). Rather, the payment discharges (or partly discharges) the surety's obligations under the contract.²⁵ Accordingly, there is no supply to the surety by the creditor in consideration of the payment by the surety.

76. The payment of money on the exercise of a right is also not a supply by the surety because of subsection 9-10(4) of the GST Act.²⁶

77. Following a payment by the surety under the guarantee or indemnity, the surety is entitled to payment from the principal under the underlying indemnity. This payment is also not consideration for the release of the principal from an obligation, nor for the surrender of the surety's rights. The payment discharges the principal's obligations under the contract or in accordance with the law. That is, there is no supply to the principal by the surety in consideration of the payment by the principal.

78. As is the case with a payment by the surety to the creditor under a guarantee or indemnity (see paragraph 76), the payment of money on the exercise by the surety of the right to be indemnified is also not a supply by the principal because of subsection 9-10(4) of the GST Act.

Payment in the hands of the creditor

79. Although the payment made by the surety is not a supply, and is not consideration for a financial supply of the release of obligations under the guarantee, it may be consideration for a supply made by the creditor to the principal.

80. Where the creditor has made a supply to the principal, payment for which is guaranteed by the surety, a payment by the surety is third-party consideration for that supply.

81. This is the case whether the payment is made under a guarantee or an indemnity. In the case of a guarantee, the payment is limited by the liability of the principal.

²⁵ This is analogous to the discharge of the judgement debtor's obligation referred to by Underwood J in *Shaw v. Director of Housing and State of Tasmania (No. 2)* (2001) 10 Tas R 1; (2001) 159 FLR 322; 2001 ATC 4054; (2001) 46 ATR 242; [2001] TASSC 2.

²⁶ Subsection 9-10(4) of the GST Act states that a supply of money is not a supply, unless it is provided as consideration for another supply of money.

Example 1

82. Tarot Corporation (Tarot) agrees to guarantee the lease payments of its subsidiary, Channel Limited (Channel), if Highrise Unit Trust (Highrise) enters into a two year lease with Channel.
83. Channel fails to make the lease payments and Tarot pays the amount owing to Highrise. The payment is consideration for the supply by way of the lease by Highrise. The payment is third party consideration by Tarot.
84. Tarot has a right of indemnity against Channel for the amount it paid Highrise.
85. In the case of an indemnity, the payment may exceed the actual consideration for the supply made to the principal, the surety being called upon to make good the loss of the creditor in full. If this is the case, the GST treatment of the payment will depend upon what the payment to the creditor is for.

Example 2

86. Channel Limited is a manufacturer of greeting cards. It does not have a good credit rating, and its suppliers of paper products are reluctant to provide further supplies on credit. Tarot Corporation, its parent company, undertakes to indemnify Papier Limited (Papier) in relation to amounts owing on paper products it supplies to Channel.
87. In the course of delivering the paper products to Channel, one of Papier's trucks is damaged on Channel's poorly maintained driveway.
88. Papier claims payment from Tarot of both the cost of the paper products and the repairs to the truck.
89. The payment that relates to the supply of paper products is third-party consideration for that supply. The part of the payment that relates to the repair of the truck is compensation for damage caused and is not consideration for a supply under the GST law.
90. Tarot has a right of indemnity against Channel for the full amount it has paid Papier.
91. This Ruling does not deal with the entitlement to, or attribution of, input tax credits when a payment is made under a guarantee or indemnity which relates to an acquisition by the principal from the creditor.

Warranties

92. Supplies of warranties are not financial supplies under item 7, except where they have the characteristics of a guarantee. This does not commonly occur.

93. In commercial parlance, the terms *warranty* and *guarantee* are sometimes used interchangeably. In general, the term *guarantee* describes a collateral contract 'by which one person is bound to another for the due fulfilment of a promise or engagement of a third party', while the term *warranty* describes 'a contract as to title, quality or quantity of a thing sold'.²⁷ Written or oral assurances as to the quality or performance of consumer goods are warranties at law, not guarantees.

94. Item 7 excludes a warranty for goods. Goods, according to the Dictionary in the GST Act, are 'any form of tangible personal property'.²⁸

95. A warranty for the quality of services, or property other than goods, although not specifically excluded, does not fall within item 7 unless it has the character of a guarantee. This is because item 7 deals with guarantees including indemnities, and only arrangements which have the characteristics of a guarantee or indemnity described in paragraphs 7 and 48 to 52 fit within the item. Should a warranty for services or property other than goods have the necessary characteristics, it will fall within the item but not the exclusion.

96. A warranty does not usually relate to the obligations of a third party. However, in some cases a warranty may be given by an entity to induce a customer to purchase goods or services from another entity. In this case, the provider of the warranty agrees to make good defects in goods or services provided to the customer, if those goods or services are not of the standard warranted by the supplier.

97. An extended warranty offered on goods, where for a fee a third party agrees to make good any faults in goods sold by a retailer for a specified period, is another example of a three party warranty. Neither this, nor the example in paragraphs 100 to 102, is a guarantee for the purposes of item 7.

98. These warranties are three-party agreements containing 'a promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction with a third party'.²⁹ Few three-party warranties, however, contain an underlying indemnity under which the surety (in this example the third party) has the right to be indemnified by the principal (in this case the retailer) for any payment made to the creditor (in this case, the customer). These warranties do not, therefore, have the relevant characteristics of a guarantee identified in paragraphs 7 and 48 to 52, and are not financial supplies under item 7.

²⁷ O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee (3rd ed)*, Law Book Company, Sydney, p. 31.

²⁸ GST Act section 195-1.

²⁹ *Sunbird Plaza* (1988) 166 CLR 245 at 254; (1988) 77 ALR 205 at 207.

99. Some guarantees may exist that take the superficial form of a warranty for goods or services. However, where these have three parties in the proper relationships, and an underlying indemnity between the entity providing the 'warranty' and the goods or services provider, the proper characterisation is as a guarantee, notwithstanding that goods or services are the subject matter of the agreement. Performance bonds for construction work are an example of this type of guarantee.

Example 3

100. Norman's, a motorcycle repairer and spare parts dealer, offers a five year warranty to purchasers of selected models of the Nippy 2000 motorbike. The Nippy 2000 comes with a one year warranty from the dealer. For a payment of \$400 Norman's agrees to repair any faults in the bike for four years after the initial warranty period. Valentino Bianco agrees to buy a Nippy 2000 from Mr. Toad's Motors and purchases the extended warranty.

101. When, one year and 10 days later, the bike develops some problems due to a faulty part, Valentino takes it back to Mr Toad's, which sends it to Norman's to make the repairs. Norman's bears the costs under the extended warranty.

102. Despite there being three parties to the agreement, this is not a guarantee under item 7, as Norman's has no right to be indemnified by Mr Toad's Motors. The supply of the extended warranty is a taxable supply for which the \$400 is consideration.

Reinsurance of surety bonds

103. Reinsurance, as discussed at paragraphs 42 to 46, is a form of insurance, and always relates to underlying contracts of insurance.

104. An exception to this occurs in relation to surety bonds under which the risk of the surety is ceded in part or wholly to another entity. These arrangements are referred to, in the surety industry, as 'reinsurance'. In these arrangements, the underlying contract is not a contract of insurance, but rather a guarantee. The so-called 'reinsurance' contract is also not a contract of insurance.

105. This 'reinsurance' of surety bond products has the same character as a surety bond product itself. That is, such arrangements involve a supply of an interest in or under a guarantee or an indemnity and are not contracts of insurance. The 'reinsurer' therefore makes a financial supply by entering into the ceding arrangement. As the recipient of the 'reinsurance', the surety also makes a financial supply, being an acquisition supply.

Examples of interests included in item 7

106. The following paragraphs discuss the transactions included in Part 5 to Schedule 7 of the GST regulations, which provide examples of interests included under item 7.

An indemnity that is not a contract of insurance

107. The first example in Part 5 of Schedule 7 to the GST regulations for item 7 is 'an indemnity that is not a contract of insurance'. Insurance is a special form of indemnity and is specifically excluded from item 7. The characteristics of those guarantees and indemnities covered by item 7 and contracts of insurance are quite different. Paragraphs 38 to 41 discuss the features of insurance.

108. Some contracts of indemnity are neither indemnities of the kind referred to in *Sunbird Plaza*,³⁰ nor contracts of insurance. These types of indemnity are not covered by item 7.

109. An example is a 'commercial' indemnity in which one entity agrees to make good the loss of a second entity in certain circumstances not involving a transaction with a third party. This type of indemnity includes income 'guarantees' in which a vendor of a business agrees to pay the difference between the estimated income from the business and the actual income to the purchaser for a given period.

110. If this type of indemnity is provided for consideration, it may be a taxable supply by the entity making the promise.³¹

A surety bond that is a guarantee

111. The second example in Part 5 of Schedule 7 for item 7 is surety bonds. Surety bonds are commercial products under which the surety undertakes to secure certain obligations owed by a principal to a creditor. Performance bonds are particular types of surety bonds.

112. Surety bonds have the character of guarantees. The provision, creation, or acquisition of an interest in a surety bond may therefore be a financial supply.

113. Supplies of interests under contracts described as surety bonds, but which are not guarantees or indemnities under item 7, are not financial supplies.

A performance bond

114. The third example of an item 7 interest is 'a performance bond'.

³⁰ See paragraphs 48-49 for a discussion of *Sunbird Plaza*.

³¹ GSTR 2003/16 paragraphs 69 and 72.

What is a performance bond?

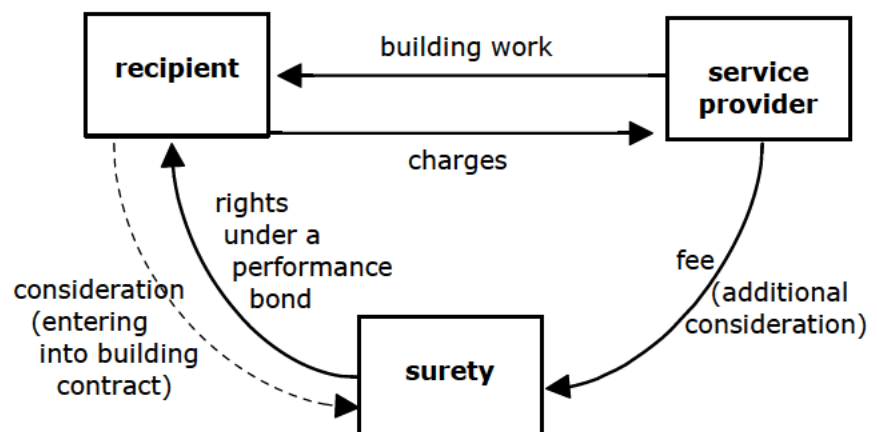
115. A performance bond is an undertaking by a person to make good a contractual obligation of another to a third party, usually on proof of the failure of that other person to perform the relevant obligation.

116. When an entity agrees to guarantee the work or performance of another under a performance bond, the entity makes a financial supply in the same manner as discussed at paragraphs 53 to 64. The supply of rights under a performance bond is a financial supply, and the consideration consists of the recipient's engagement of the service provider, together with any fees the service provider pays for the guarantee.

117. The entry into the contract with the service provider is not a supply by the recipient to the surety for the purposes of the GST law.

118. The diagram below sets out the flow of obligations and consideration under a typical performance bond for building work. The recipient enters into a building contract with the principal. The service provider pays the surety to provide rights under a performance bond to the recipient (a financial supply). The surety receives consideration from two sources: the recipient and the service provider.

Figure 2: Flow of supplies and consideration under a performance bond



119. Performance bonds are used in large-scale project financing transactions. An example arising in the construction industry is an unconditional undertaking from a financial institution or insurance company addressed to a proprietor of land, in which the institution or company promises to pay the proprietor the amount set out in the undertaking on demand from the proprietor.³²

³² *Butterworths Australian Legal Dictionary*, 1997, Butterworths, Sydney, p. 866.

120. Some performance bonds contain an option for the surety to perform the contract rather than pay the relevant amount, while, rarely, others will require performance only.

121. Performance bonds may be conditional or unconditional. A conditional performance bond imposes a secondary obligation on the surety and is only enforceable on breach by the service provider.

122. An unconditional performance bond permits the recipient to call first upon the surety, and does not require proof of a breach before it is invoked.

123. Performance bonds may also be known as 'bank guarantees' or 'insurance bonds'. These terms indicate the nature of the entity providing the assurance, and generally refer to unconditional performance bonds.

124. Insurance bonds that are issued by an insurance company are distinct from contracts of insurance. Although the example itself does not make this qualification, to the extent that a product is a contract of insurance, the example in Schedule 7 will be inconsistent with the description in item 7 and the description will prevail.³³ In these circumstances, the product would not be covered by item 7.

125. Whatever name is given to the product, it falls within item 7 if it has the characteristics of a guarantee or an indemnity described in paragraphs 7 and 48 to 52. The effect of payments or supplies made under these products is dealt with below.

Supplies made under performance bonds

126. In commercial practice, performance bonds are given for the quality, timeliness, or some other measure of supplies being made to an entity. In this case, the recipient has contracted for the service provider to make a supply to the recipient. The surety guarantees the quality or timeliness of the completed work.

127. If the work is not satisfactorily completed, the recipient has the right to call on the surety under the bond (often without calling on the service provider in the case of an unconditional bond). The surety may choose to complete or repair the work instead of making a payment, if this is allowed in the bond document, and there is no legal impediment.

128. Whether the surety pays an amount or makes a supply, the payment or supply is not consideration for the release from an obligation for the same reasons discussed in paragraph 76.

129. If the surety makes a cash payment, the payment is not a supply.³⁴

³³ See Note 2 to regulation 40-5.11 and section 15AD of the *Acts Interpretation Act 1901*.

³⁴ Subsection 9-10(4) of the GST Act.

130. If the surety makes a supply of work and the recipient provides no additional consideration to the surety when it performs the work, there is no consideration for the supply. There is, therefore, no taxable supply by the surety.³⁵

131. In some performance bond contracts, the recipient is not interested in compensation for uncompleted work, but simply wants assurance that the surety will complete the work if the service provider does not. Even where no provision is made in the performance bond for the surety to make a cash payment, the surety's supply of the rights under the performance bond to the recipient is a financial supply in common with other performance bonds and standard guarantees.

132. If the payments under the underlying contract (for example, a construction contract) have all been made to the original contractor, and no payments are made to the surety for the completion of the contract, the supply of completing the contract is for no consideration, and is not a taxable supply by the surety.

133. If, under the terms of the contract between the parties, the recipient pays part of the consideration for the work to the surety, this is consideration for a taxable supply of the work the surety performs, as distinct from a supply of rights under the performance bond.

134. Under all of these circumstances, the surety has a right to be indemnified by the service provider. But this underlying indemnity is not regarded as a separate supply (see paragraph 139).

Payment or supplies under a performance bond in the hands of the recipient

135. The recipient in a contract for services (for example, building services) contracts for an outcome. A performance bond guarantees that outcome.

136. If the supply that the service provider makes to the recipient is inferior or incomplete, and the recipient receives a payment from the surety, this payment is made to meet the surety's obligations under the performance bond. It is not an adjustment to the price of the original supply, nor is it consideration for a separate supply by the recipient.

137. The effect of the surety choosing to complete or repair the work is as follows. The recipient contracts for a completed job of a certain standard, and the job is completed to that standard by the surety. The recipient achieves what it contracted for, but by way of supplies by two entities instead of one. One of the entities (the service provider) makes a taxable supply, while the other (the surety), provided it received no payment from the recipient, makes a supply for no consideration.

³⁵ Subparagraph 9-15(3)(a)(ii) of the GST Act.

138. If some of the payments for the work are actually made to the surety, both entities make a taxable supply in completing the job the recipient contracted for.

139. Whether the surety makes a payment or completes the work, it is entitled to be indemnified by the service provider for the payment or the value of the work done. As with other guarantees and indemnities (see paragraphs 65 to 69), the underlying indemnities arising incidentally out of performance bonds are not separate supplies, and, therefore, do not involve financial supplies.

Detailed contents list

140. Below is a detailed contents list for this Goods and Services Tax Ruling:

	Paragraph
What this Ruling is about	1
Date of effect	4
Frequently used terms	6
'Guarantee' and 'indemnity'	6
Terms for the parties to a guarantee or indemnity arrangement	9
Terms used for parties to a guarantee of performance under a contract of service	17
Deeds of guarantee	19
Background	20
Guarantees and indemnities in GST	20
Guarantees and indemnities in general law	24
Statute of Frauds	29
Warranty	33
Insurance	38
Reinsurance	42
Performance bonds	47
Ruling and Explanation	48
The meaning of item 7: 'guarantee, including indemnity'	48
Guarantees	53
<i>Supply of an interest in a guarantee</i>	56
<i>The underlying indemnity</i>	65
Indemnities	70
Payment under a guarantee or indemnity	74

Payment in the hands of the creditor	79
<i>Example 1</i>	82
<i>Example 2</i>	86
Warranties	92
<i>Example 3</i>	100
Reinsurance of surety bonds	103
Examples of interests included in item 7	106
<i>An indemnity that is not a contract of insurance</i>	107
<i>A surety bond that is a guarantee</i>	111
<i>A performance bond</i>	114
<i>What is a performance bond?</i>	115
<i>Supplies made under performance bonds</i>	126
<i>Payment or supplies under a performance bond in the hands of the recipient</i>	135
Detailed contents list	140

Commissioner of Taxation

22 March 2006

<i>Previous drafts:</i>	- reinsurance
GSTR 2005/D2	- rights
	- Statute of Frauds
<i>Related Rulings/Determinations:</i>	- surety
GSTR 1999/1; GSTR 2002/2;	- surety bond
GSTR 2003/16; TR 96/23	- three-party contract
	- utmost good faith
	- warranty
<i>Subject references:</i>	<i>Legislative references:</i>
- contract	- AIA 1901 15AD
- creditor	- ANTS(GST)A 1999 9-10(2)(e)
- debtor	- ANTS(GST)A 1999 9-10(2)(g)
- deed of guarantee	- ANTS(GST)A 1999 9-10(4)
- financial interest	- ANTS(GST)A 1999 9-15(3)(a)(ii)
- financial supply	- ANTS(GST)A 1999 40-5
- financial supply provider	- ANTS(GST)A 1999 195-1
- guarantee	- ANTS(GST)R 1999 Subdiv 40-A
- guarantor	- ANTS(GST)R 1999 40-5.06(2)
- indemnifier	- ANTS(GST)R 1999 40-5.09(1)
- indemnity	- ANTS(GST)R 1999 40-5.09(3)
- input taxed supply	- ANTS(GST)R 1999 40-5.11
- insurance	- ANTS(GST)R 1999 Sch 7 Pt 5
- obligee	- ITAA 1997 104-25
- obligor	- Statute of Frauds 1677 (UK)
- performance bond	- TAA 1953 37
- principal	

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- SH Lock Discounts & Credits Pty Ltd v. Miles [1963] VR 656
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- Sunbird Plaza Pty Ltd v. Maloney (1988) 166 CLR 245; (1988) 77 ALR 205
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