TR 93/21 - Income tax: timing of deductions for discounts on commercial bills with a term of less than 12 months

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Australian Taxation Office

Taxation Ruling
Income tax: timing of deductions for discounts on commercial bills with a term of less than 12 months

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling considers the deductibility of discounts on bills of exchange and promissory notes (in this Ruling referred to as a commercial bill) following the decision of the High Court Of Australia in *Coles Myer Finance Ltd. v FC of T* 93 ATC 4212, 25 ATR 95. In particular the Ruling is concerned with the timing of deductions where the term of a commercial bill extends beyond the year in which it is drawn.

2. This Ruling does not deal with the timing of deductions in those cases where the discount expense is pre-paid. This matter will be covered in a separate Ruling.

Ruling

3. We accept that commercial bill discount expenses are generally an allowable deduction as an expense of raising finance provided that the proceeds of the bill are used in an assessable income producing business or activity. We are of the opinion that the decision in *Coles Myer Finance*, in relation to discount expenses, is not limited to financial institutions. The decision applies to all taxpayers who use commercial bills to raise funds to be used in their assessable income producing business or activity and whose taxable income is calculated on an accruals basis.

4. The issuing of a commercial bill gives rise to a presently existing legal liability on the part of the issuer to meet the bill at a future date. That liability establishes that the issuer has an obligation

to pay an amount which gives rise to a net loss or outgoing (*Coles Myer Finance* ATC 4222, ATR 105).

5. A deduction for the discount expense is allowable under subsection 51(1) of the *Income Tax Assessment Act 1936* (ITAA) over the years of income that correspond with the term of the bill (*Coles Myer Finance* ATC 4222, ATR 105). It is therefore necessary to apportion the amount of the discount to determine the deduction allowable in each year of income where the term of the bill extends over more than one income year.

6. In the case of commercial bills with a term of less than 12 months, the discount should be apportioned on a straight line basis over the term of the relevant bill (*Coles Myer Finance* ATC 4223, ATR 106).

7. Division 16E of Part III of the ITAA will apply to all commercial bills with a term greater than 12 months.

Date of effect

8. This Ruling applies to years commencing both before and after its date of issue. The following arrangements apply to assessments incorrectly made before the issue of this Ruling:

(a) If a taxpayer has been allowed deductions in the 1989-90 and/or subsequent years for bill discount expenses in the year of income in which the bill was issued then all assessments in which the deduction has been allowed on this basis should be amended in accordance with this Ruling (to the extent allowed under section 170).

(b) Taxpayers who have been allowed deductions for bill discount expenses in the year of income in which the bill matured may, if they wish, seek amended assessments (to the extent allowed by section 170).

(c) In relation to bills which issued in the 1991-92 year, taxpayers may deduct the full amount of the discount expense in the 1992-93 year instead of amending the 1991-92 assessment to deduct the discount on an accruals basis.

9. Notwithstanding paragraph 8, the terms of an agreed settlement between a taxpayer and this Office will not be disturbed (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Penalties and interest

10. If assessments are amended in accordance with paragraph 8 (a) above, the question of the imposition of penalty and interest on underpayments needs to be considered. Guidelines for the remission of penalty and interest are contained in Taxation Rulings IT 2444, 2517, 2593 and TR 92/10. In applying those guidelines we accept that prior to the High Court's decision in *Coles Myer Finance* there was a 'reasonably arguable' position, within the meaning of sections 160ARZD and 226K of the ITAA, that bill discount expenses were deductible in full in the year in which the commercial bill was issued. We also accept that the issue was a 'contentious' item within the meaning of that term in Taxation Ruling IT 2517. We are therefore of the view that, as a general rule, a full remission of the 'culpability' component of any penalty is warranted.

11. However, in respect of those taxpayers who, in taxation returns lodged after 5 February 1991 (the date on which the Full Federal Court hand down its decision in *Coles Myer Finance*), claimed discount deductions in the year of income in which the commercial bill was issued a per annum interest component of 10% is generally warranted (see paragraph 13 of TR 92/10).

12. Likewise, in accordance with the guidelines in IT 2444, on the remission of interest payable under section 170AA of the ITAA, we are of the view that remission is not generally warranted in respect of returns lodged after 5 February 1991 where a discount deduction was claimed in the year of issue of the commercial bill. A remission in full will generally be warranted in respect of returns lodged prior to that date.

Explanations

Background

13. When used to raise finance a bill of exchange is known commercially as an accommodation bill. Broadly speaking, an accommodation bill is a bill which has been accepted (normally by a bank) in order to enable the drawer (ie, a client of the bank) to raise money upon it. Because of the standing of the bank these bills are easily marketable. The accepting bank is known as the accommodation party and its client (the drawer) is the party accommodated. The accommodation party is liable on the bill to a holder for value but receives an indemnity in respect of its liability from the party accommodated.

14. By drawing an accommodation bill a taxpayer is able to raise funds at commercial rates from a third party who purchases the bill at

a discount (in some cases the bank itself will discount the bill). Such bills may be drawn on a one-off basis or, more typically, within the framework of a bill acceptance facility provided for the taxpayer by the bank.

15. Under a typical facility agreement a bank accepts a bill of exchange drawn by the taxpayer which is payable after a fixed period (normally either 90 or 180 days). The bill is then negotiated at a discount either to the accepting bank or to a third party and the proceeds remitted to the taxpayer.

16. At the time the bill matures the accepting bank has an obligation to redeem the bill at its face value. The drawer of the bill has an obligation to pay to the bank an amount equal to the face value of the bill. There are three ways in which the drawer can meet this obligation:

(a) paying the holder of the bill directly at maturity;

(b) putting the accepting bank in funds before the bill matures;

(c) indemnifying the accepting bank after the bank has paid the holder.

17. Generally, the amount paid by the drawer to discharge their obligation under the bill is in part obtained by drawing a new bill which is then negotiated. The balance is made up by the drawer from other sources. This process is repeated each time a bill matures. The continuous series of discounting transactions or 'roll-overs' ensures that the drawer need only use its own funds to pay the discount expense at each roll-over date. At the end of the facility period the drawer meets its obligation to the bank in respect of the last-drawn bill completely from other sources.

Timing of deductions

18. Generally it is a pre-condition of deductibility under subsection 51(1) that there be a presently existing legal liability or obligation which is due but not necessarily payable (*Nilsen Development Laboratories Pty. Ltd. v FC of T* 81 ATC 4031 at 4034-35, 11 ATR 505 at 509; *FC of T v James Flood Pty. Ltd.* (1953) 88 CLR 492; *Coles Myer Finance* ATC 4220, ATR 103).

19. A presently existing legal liability or obligation to pay an amount in a future year will not necessarily mean that amount is fully deductible in the year in which the legal liability or obligation first came into existence. Regard must also be had to the years of income to which the expense is properly referable. As the High Court said in *Coles Myer Finance* ATC 4222, ATR 105:

> 'The acceptance by this Court of the jurisprudential analysis of s.51(1) does not compel the conclusion that, once a taxpayer subjects itself in the year of income on revenue account to a present legal liability to pay in a future year of income an amount which generates, or gives rise to, a net loss or outgoing, the net loss or outgoing is deductible in full in the year of income. The relevance of the present existence of a legal liability on the part of the taxpayer to meet the bills and notes at a future date is that it establishes that the taxpayer has "incurred" in the year of income an obligation to pay an amount which gives rise to a net loss or outgoing, being the recurrent cost of acquiring working or circulating capital. *But there remains the question: how much of that net loss or outgoing is referable to the year of income.'* (emphasis added)

20. The deduction in respect of a bill discount must be apportioned over the period in which the funds acquired by the issuing of the bill are 'put to profitable advantage'. In *Coles Myer Finance* (ATC 4222, ATR 105) it was stated that:

> 'Although the legal liability to pay is incurred in the year of income, the amount in question is not payable until the subsequent year of income and, more importantly, the net loss or outgoing represents the cost of acquiring funds which the taxpayer puts to profitable advantage in both years of income'.

In the High Court's view the apportionment of the discount expense is consistent with the 'matching principle' in accounting (*Coles Myer Finance* ATC 4222, ATR 105).

21. The most appropriate method of apportionment for short term bills is a straight line basis. The majority of the High Court in *Coles Myer Finance* (ATC 4223, ATR 106) stated that:

> '... it follows that the total cost should be apportioned and, having regard to the relatively short life of the bills and notes, the apportionment should be on a straight line basis over the term of the relevant note or bill.'

Example

22. The AB Corporation drew a commercial bill with a face value of $1000 and a 90 day term. The bill was sold to an arm's length purchaser for $940 on 1 June 1993. The Corporation has a presently existing legal obligation to pay $1000 on 29 August 1993. The amount of the discount of $60 is apportioned on a straight line basis over the period 1 June to 29 August, inclusive. Therefore $20 is deductible in the 1993 year of income and $40 is deductible in 1994.

Commissioner of Taxation

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- ITAA 51(1)
- ITAA Pt III Div 16E

case references
- Coles Myer Finance Ltd v. FC of T
  1993 ATC 4212
  25 ATR 95