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

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Taxation Ruling
Income tax: capital gains: implications of a guarantee to pay a debt

other Rulings on this topic

TD 2; TD 3; IT 2606; TR 95/3; TR 96/14

contents	para
What this Ruling is about	**1**
Class of person/arrangement	1
Definition	**5**
Ruling	**6**
Principal debtor (i.e., borrower)	8
The creditor (i.e., lender)	9
The guarantor	30
Date of effect	**48**
Explanations	**49**
General law	49
Principal debtor	52
The creditor	54
The guarantor	84
Acquisition of the guarantor's assets	88
Examples	**158**
Tables	**169**
Detailed contents list	**170**

*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.*

What this Ruling is about

Class of person/arrangement

1. This Ruling considers the capital gains implications under Part IIIA (and to a lesser extent subsection 51(1)) for a guarantor, together with the Part IIIA consequences for a debtor and creditor when a payment is made in relation to a contract of guarantee. Any references to sections or Parts in this Ruling are a reference to sections and Parts of the *Income Tax Assessment Act 1936*.

2. The types of guarantees dealt with in this Ruling are:

   (a) a guarantee by a shareholder for a private company debt;

   (b) a guarantee by a company for another company's debt;

   (c) a guarantee by a family member for another family member's debt.

3. The Ruling does not consider:

   (a) the deductibility of guarantee payments under section 70B;

   (b) indemnities, assurances or letters of comfort;

   (c) a guarantee where it guarantees performance of a contractual obligation which does not involve the payment of money; and

   (d) a guarantee by a trustee of a trust in respect of the activities of the trust.

4. The Ruling proceeds on the assumption that the principal debtor requested (expressly or impliedly) the guarantee in order to obtain a

loan or other credit from the creditor (this is relevant in the context of a guarantor's right of indemnity). The Ruling covers the majority of commercial debt guarantee cases, that is, where there is a contractual right of indemnity arising to the guarantor and, typically (though not exclusively), a debt on which a commercial interest rate is imposed.

Definition

5. *The CCH Macquarie Concise Dictionary of Modern Law* defines a 'guarantee' as 'a contract wherein one party (the surety) gives a second party an undertaking to answer for any debt or default of a third party in respect of a dealing between the second and third parties'. *Halsbury's Laws of Australia*, vol 14 at 401,021, paragraph 220-1 says that a contract of guarantee is, subject to any qualifications made by the particular instrument, a collateral contract to answer for the debt, default or miscarriage of another who is, or is contemplated to be, or to become, liable to the person to whom the guarantee is given.

Ruling

6. The capital gains tax consequences for a principal debtor, a creditor and a guarantor of a payment made by the guarantor under a contract of guarantee are summarised in the Tables at paragraph 169 of this Ruling.

7. A capital loss is not incurred by a guarantor if a debt arising to the guarantor under a right of indemnity or a right of subrogation, on payment, is a 'personal-use asset' for the purposes of subparagraph (b)(ii) of the definition in subsection 160B(1). This is so because Part IIIA does not recognise capital losses incurred on the disposal of such assets: subsection 160Z(7) (see paragraph 46 below). If the debt came to be owed to the guarantor otherwise than in the course of gaining or producing income or in carrying on a business, it is a personal-use asset. If payments are made by a guarantor under a guarantee, a deduction under subsection 51(1) may arise. To the extent that subsection 51(1) applies, the capital loss is reduced by the effect of subsection 160ZK(1).

Principal debtor (i.e., borrower)

8. If a payment is made by a guarantor, there are no capital gains tax consequences for the principal debtor (the person creating the debt

by borrowing money or obtaining credit from the creditor) because that person does not own nor dispose of any asset.

The creditor (i.e., lender)

Acquisition and disposal of the assets

9. The creditor, at law, can demand recovery from either the debtor or the guarantor (once default has occurred) or partly from one and partly from the other. However, the creditor cannot recover an amount greater than the amount of the loan moneys (including accrued interest, according to the terms of the guarantee).

10. To the extent that there is a shortfall between loan moneys and the amount the creditor recovers from the debtor and the guarantor, that shortfall is attributed to the primary asset (being the debt) of the creditor. The debt is the primary asset because the guarantee is given in support of the debt.

(i) Debt

11. A creditor has an initial asset, being the debt owed by the principal debtor. The creditor is taken to have acquired the debt from the debtor at the time of making the loan.

(ii) Contractual rights under the guarantee

12. 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. The creditor is taken by paragraph 160M(6B)(a) to have acquired the rights under the guarantee from the guarantor and to have commenced to own the contractual rights at the time specified in subparagraph 160U(6)(a)(i), i.e., at the time of the making of the contract of guarantee.

Cost base of the debt

13. The creditor's cost base, indexed cost base or reduced cost base ('relevant cost base') for the debt is the amount of the debt; that is, the amount the creditor pays or is required to pay 'in respect of the acquisition' of the debt in terms of paragraph 160ZH(1)(a), (2)(a) or (3)(a) as defined in paragraph 160ZH(4)(a), unless the transaction is not at arm's length.

Cost base of the contractual rights under the guarantee

14. The consideration given by the creditor in respect of the acquisition of the contractual rights under the guarantee is the promise of the creditor to make a loan, or extend or maintain credit, to the debtor. The contractual consideration is 'consideration in respect of the acquisition of an asset' for the purposes of paragraph 160ZH(1)(a), (2)(a) or (3)(a) as defined in subsection 160ZH(4)(b), being 'property other than money'. If the taxpayer has given, or is required to give, property other than money in respect of the acquisition of an asset, the consideration in respect of the acquisition of the asset is the market value of that property at the time of the acquisition. We consider that there is no market for the creditor's promise to the guarantor to make a loan or extend credit to the debtor. We conclude, therefore, that the market value is nil. The creditor, while obtaining two assets, cannot recover more than the face value of the loan to the debtor, so that the consideration for the guarantee (relevant cost base) is sensibly to be determined as having a nil value.

Principal debtor pays the debt in full

15. If the principal debtor pays the debt, the debt is taken (by paragraph 160M(3)(b) and subsection 160M(1)) to be disposed of by the creditor by way of satisfaction. The consideration received for the disposal in terms of subsection 160ZD(1) is the amount of the debt paid, which is equal to the cost base of the debt (see paragraph 13 above). No capital gain accrues to the creditor and no capital loss is incurred on the disposal of the debt.

16. Because the principal debtor pays the whole of the guaranteed debt, the rights under the guarantee are taken (by paragraph 160M(3)(b) and subsection 160M(1)) to be disposed of by release, discharge or satisfaction. The guarantor has nothing to pay; therefore the disposal of the rights by the creditor is for no consideration. Because the debt is repaid by the debtor, market value of the right to call on the guarantor for payment is nil, applying the deemed market value rules in paragraph 160ZD(2)(a) and subsection 160ZD(2A). No capital gain or loss therefore arises on the disposal of the contractual rights under the guarantee.

Guarantor pays the guaranteed amount in full in satisfaction of the debt owing

17. If the guarantor is called on to pay the debt under the guarantee (for example, on default by the principal debtor), there is a disposal of the rights under the guarantee for the purposes of paragraph 160M(3)(b) and subsection 160M(1). The consideration which the

creditor receives, or is entitled to receive, in terms of subsection 160ZD(1) on the disposal is the amount the guarantor pays under the guarantee. Therefore, a capital gain accrues to the creditor for the amount of the payment made under the guarantee.

18. Because the guarantor pays the guaranteed amount in full in satisfaction of the debt owing, the debt is taken (by paragraph 160M(3)(b) and subsection 160M(1)) to be disposed of by release, discharge or satisfaction. The principal debtor has nothing to repay to the creditor; therefore, the disposal of the debt by the creditor is for no consideration. Because the principal debt is extinguished on payment by the guarantor, market value of the right to call on the debtor for payment is nil, applying the deemed market value rules in paragraph 160ZD(2)(a) and subsection 160ZD(2A). A capital loss therefore arises on disposal of the debt. The capital loss is incurred under paragraph 160Z(1)(b), equal to the reduced cost base of the debt. This loss offsets the gain accruing to the creditor under the guarantee.

Principal debtor pays part of debt and guarantor pays balance

19. In this situation, the creditor recovers the amount of the debt partly from the debtor and partly from the guarantor. Because the whole of the debt is repaid, the debt is taken (by paragraph 160M(3)(b) and subsection 160M(1)) to be disposed of by the creditor by way of satisfaction. As the debt is fully repaid, the rights under the guarantee are also taken to be disposed of by release, discharge or satisfaction (paragraph 160M(3)(b) and subsection 160M(1)). To the extent that the creditor recovers from the guarantor, a capital gain will arise for the amount of the payment (less indexation, if any, and incidentals). The consideration which the creditor receives in terms of subsection 160ZD(1) on the disposal of the debt is the amount the debtor repays. The creditor cannot recover more than the value of the loan. Any amount recovered from the debtor reduces the capital loss arising on disposal of the debt. The capital loss offsets the capital gain accrued on disposal of the guarantee.

Creditor recovers less than the amount of the loan

20. If the creditor recovers **part only** of the debt owed, the creditor may recover:

(1) part repayment from the debtor and part of the balance of the debt from the guarantor;

(2) part repayment from the debtor but nothing from the guarantor;

(3) part payment from the guarantor but nothing from the debtor.

21. Because the amount of the debt in these situations is not fully repaid, then, assuming the guarantee is for the full amount of the debt, neither the debt nor the guarantee is disposed of by way of satisfaction. If, however, the guarantee is only for part of the debt and the guarantor pays the full amount due under the guarantee, the guarantee is disposed of by way of satisfaction (paragraph 160M(3)(b) and subsection 160M(1)) and a capital gain accrues to the extent of the payment.

22. While still assuming that the guarantee is for the full amount of the debt, if the creditor recovers one third of the debt from the debtor and one third from the guarantor but fails to recover the remaining one third, a capital gain accrues to the creditor on disposal of the guarantee rights. As previously noted (see, for example, paragraphs 16 and 19), the discharge of the debt brings about a discharge of the creditor's rights under the guarantee and thus a disposal of such rights (paragraph 160M(3)(b) and subsection 160M(1)). Thus, on a release by the creditor of the balance owing under the debt, not only will the debt be extinguished or discharged (and thus disposed of for capital gains purposes) but so also will the creditor's rights under the guarantee. The consideration received on the disposal of the debt is the amount of the payment recovered from the debtor (see paragraph 15 above). A capital loss is incurred under paragraph 160Z(1)(b) for the amount of the shortfall. The capital gain accruing on the disposal of the guarantee is reduced by the capital loss on disposal of the debt. However, if the creditor specifically releases the guarantor before releasing the debtor, it is essential for the offsetting of the capital gain and capital loss, that the creditor disposes of both the guarantee (by discharge or release) and the debt (by release) in the same year of income.

23. If the creditor recovers part of the debt from the debtor but nothing from the guarantor and the debt is released, the rights under the guarantee are disposed of by way of release or discharge (paragraphs 160M(3)(b) and subsection 160M(1)) for no consideration. A capital loss is incurred under paragraph 160Z(1)(b) for the amount not recovered on the debt. If the creditor, without having received full payment from the debtor, nevertheless agrees to release the debtor from any further liability the guarantor is absolutely discharged. Because the debt ceases to exist for capital gains tax purposes, market value of the right to call on the guarantor for payment is nil, applying the deemed market value rules in paragraph 160ZD(2)(a) and subsection 160ZD(2A). No capital gain therefore accrues on the disposal of the guarantee.

24. If, however, the creditor recovers part of the debt from the guarantor but nothing from the debtor, a capital loss is incurred on the disposal of the debt (depending on the deemed market value of the debt at the time of disposal: paragraph 160ZD(2)(a) and subsection 160ZD(2A)). A capital gain arises to the extent of the payment under the guarantee on disposal of the rights under the guarantee: paragraph 160Z(1)(a). A capital loss incurred on the disposal of the debt reduces the capital gain on the guarantee, assuming the loss and gain both occur during the one year of income.

25. It is our view that the part payment of the debt (either by the debtor or the guarantor) does not bring about a part disposal of the debt for the purposes of section 160R and that the debt is only disposed of when it is discharged by payment in full (or by release). It follows, in our view, that a part payment by the guarantor of the amount payable under the guarantee does not bring about a part disposal of the creditor's rights under the guarantee. Also, a part payment of the debt by the debtor does not bring about a part disposal of the creditor's rights under the guarantee. The guarantee will be disposed of when either the debt is extinguished by payment (discharged) or by release or partly by one means and partly by the other; or the guarantor has paid the full amount due under the guarantee (taking into account any payments made by the debtor).

Both the debtor and the guarantor default on request for repayment and both the guarantor and debtor are insolvent

26. In this situation, where there is a disposal of the debt by release or discharge, a capital loss is incurred. The deemed market value rules apply to the disposal: paragraph 160ZD(2)(a) and subsection 160ZD(2A). If the debtor is insolvent, the market value of the debt is nil. The guarantee, which has a nil cost base, is itself automatically disposed of by release or discharge, on release or discharge of the debt, for no consideration. As the guarantor is insolvent, the market value of the guarantee would be nil and therefore no capital gain would accrue on discharge of the guarantee.

Creditor receives payment from solvent guarantor or releases guarantee before discharge of the debt

27. Conversely, if the guarantor is solvent and the creditor pursues recovery from the guarantor, while the principal debt remains on foot, there will be a capital gain on the disposal of the creditor's rights under the guarantee by virtue of the payment in full of the amount due under the guarantee by the guarantor. Further, if no (or a lesser) payment is made by the guarantor and the guarantee is specifically

disposed of by release or discharge, the market value rules will apply: paragraphs 160ZD(2)(a) and 160ZD(2)(c) and subsection 160ZD(2A). As the guarantor is solvent, the rights released by the creditor will have a market value equal to the amount which would have been payable under the guarantee.

Creditor forgives the debt

(i) Debt

28. If a creditor forgives a debt, the debt (which was acquired by the creditor for the amount advanced to the debtor) is taken (by paragraph 160M(3)(b) and subsection 160M(1)) to have been disposed of by the creditor by way of release. No consideration is received by the creditor for the forgiveness of the debt. Whether a capital loss is incurred on the forgiveness of the debt depends on the deemed market value of the debt at the time of disposal: paragraph 160ZD(2)(a) and subsection 160ZD(2A) (see Taxation Determination TD 2).

(ii) Contractual rights under the guarantee

29. When the creditor forgives the principal debt, the rights under the contract of guarantee are (by paragraph 160M(3)(b) and subsection 160M(1)) taken to be disposed of by way of release. No consideration is in fact received by the creditor for the contractual rights under the guarantee, which are disposed of on the forgiveness of the debt. Although paragraph 160ZD(2)(a) and subsection 160ZD(2A) deem market value of the rights to have been received by the creditor, this value is nil if the debt is forgiven. No capital gain or loss is therefore incurred on the disposal of the rights.

The guarantor

Acquisition of rights by a guarantor

The guarantor's right of indemnity

30. 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.

31. The guarantor is taken to acquire the right of indemnity by paragraph 160M(6B)(a) (disregarding incidental costs incurred) for a cost base equal to the amount the guarantor pays, or is required to pay, under the contract of guarantee (for the purposes of paragraphs 160ZH(1)(a), (2)(a), (3)(a) and (4)(a)).

The guarantor's right of subrogation

32. When a creditor's debt is paid **in full** (whether or not it is paid in full by the guarantor paying under the guarantee), the guarantor has the right to be subrogated to the rights of the creditor - provided the guarantor's right of indemnity still exists at the time of the payment. The right to be subrogated, a doctrine of equity which has been codified by statute, is a right to stand in the place of the creditor and be subrogated to the creditor's remedies against the principal debtor. The right of subrogation can be invoked by a guarantor against a principal debtor as a way of enforcing the guarantor's right of indemnity. At general law, the right of subrogation is not severable and it is merely a means of enforcing the right of indemnity.

33. The right of subrogation does not arise in all cases (for example, when the creditor's debt is not paid out in full, or if the right of indemnity has been assigned by the guarantor before payment in full). The right of subrogation is an asset created solely by virtue of the guarantor's payment (i.e., there is no assignment of the creditor's rights to the guarantor; the right is a new right which did not previously exist). The asset is deemed to have been acquired by the guarantor under paragraph 160M(5)(b) and the time of acquisition is governed by subsection 160U(5). It is taken to be acquired on payment.

34. The guarantor is taken to acquire the right of subrogation (disregarding incidental costs incurred) for a cost base equal to the amount the guarantor pays, or is required to pay, under the contract of guarantee (for the purposes of paragraphs 160ZH(1)(a), (2)(a), (3)(a) and (4)(a)).

35. We consider that for Part IIIA purposes when the guarantor is subrogated to the rights of the creditor, the guarantor's right of subrogation is in effect subsumed by, or merged into (without there being any disposal), the guarantor's right of indemnity. The right of indemnity and the right of subrogation become co-extensive once payment is made by a guarantor under the guarantee.

36. Subsection 160ZH(12) applies to determine the cost base for Part IIIA purposes of the merged asset (paragraph 160ZH(12)(a)) or

the transformed asset (paragraph 160ZH(12)(b)). The cost base of the merged or transformed asset ('the relevant asset') is determined at the time the event happens which causes the change in the asset, namely, the acquisition of the right of subrogation: subsection 160ZH(13). The relevant cost base of the merged or transformed asset at the time of disposal **includes**, to the extent reasonable, the relevant cost base of the original asset (being the right of indemnity: see paragraph 31 above) calculated as if there had been a disposal of the right of indemnity when the relevant event occurred (i.e., at the time the right of subrogation arose): subsection 160ZH(13). The cost base of the right of subrogation will never be more than the amount paid under the guarantee (that is, the limit of the guarantor's right of recovery) and the cost base of the merged or transformed asset will likewise never be more than the amount paid under the guarantee. It is reasonable that the cost base of this merged asset does not include the (notional) amount paid or given for the original asset. It follows that the merged asset has a relevant cost base of the amount paid under the guarantee.

The right of indemnity is a debt for the purposes of Part IIIA

37. We consider that, on payment by the guarantor under the guarantee, the right of indemnity (or the merged asset if there is a right of subrogation) is enforceable as a debt against the principal debtor: see *Re a Debtor* [1937] Ch 156 at 161 per Slessor LJ; *Re Mitchell; Freelove v. Mitchell* [1913] 1 Ch 201 at 206; [1911-13] All ER 187 at 189; *Sunbird Plaza Proprietary Limited v. Maloney and Another* (1988) 166 CLR 245 at 254; 77 ALR 205 at 207 per Mason CJ. As a creditor of the principal debtor, the guarantor has the general rights of a creditor, including, for example:

(a) the right to sue on the indemnity; and

(b) in the case of a corporate debtor, the right to apply for a winding-up: see *Halsbury's Laws of Australia*, vol 14 at 401,321-2, paragraphs 220-285.

Because the right of indemnity on payment by the guarantor is in the nature of a debt for Part IIIA purposes, it may give rise to a capital loss if it is disposed of for no consideration, or it may be a 'personal-use asset' as defined in subparagraph (b)(ii) of the definition in subsection 160B(1), so that a capital loss does not arise on its disposal (refer to paragraph 46 below).

Disposal of the debt by the guarantor

38. The principal debtor may repay the underlying debt to the creditor, or the creditor may forgive the debt. In these circumstances,

the guarantor is not required to pay the underlying debt on behalf of the debtor. On payment by the debtor or forgiveness by the creditor of the debt, the right of indemnity is disposed of by discharge or release: paragraph 160M(3)(b) and subsection 160M(1). In this case, the guarantor does not make any payment under the guarantee and therefore gives no consideration for the right of indemnity and no right of subrogation ever arises to the guarantor. No market value consideration is deemed to have been given by the guarantor for the right of indemnity (paragraph 160M(6B)(b)). On disposal of the right of indemnity, the guarantor receives no consideration. However, paragraph 160ZD(2)(a) applies to deem market value consideration to have been received by the guarantor. By subsection 160ZD(2A), the right is valued at the time of disposal as if the disposal had not occurred and was never proposed to occur. The right of indemnity is valued the moment before it goes out of existence at which time, the underlying debt having been discharged, the right has a nil market value. No capital gain or loss arises on this disposal.

39. The right of indemnity may be disposed of by being assigned for consideration; there is a change of ownership under paragraph 160M(2)(b), (e) or (f) and subsection 160M(1). Therefore, a capital gain may accrue under subsection 160Z(1) or a capital loss may be incurred (provided payment has been made: see paragraph 118 below).

40. If there is no likelihood that the principal debtor will pay the debt owing to the guarantor (e.g., because the principal debtor is insolvent), the guarantor must take some action in terms of paragraph 160M(3)(b) to cause a change of ownership, and thus a disposal of the debt in terms of subsection 160M(1).

41. If the guarantor forgives the debt, the debt (which was acquired by the guarantor for the amount paid under the guarantee) is taken (by paragraph 160M(3)(b) and subsection 160M(1)) to have been disposed of by the guarantor by way of release. No consideration is received by the guarantor for the forgiveness of the debt. Whether a capital loss is incurred on the disposal of the debt depends on the deemed market value of the debt: paragraph 160ZD(2)(a) and subsection 160ZD(2A) (see Taxation Determination TD 2); and on whether the debt is a personal-use asset.

42. The principal debtor may be discharged from bankruptcy or be liquidated (in the case of a company). If the principal debtor is discharged from bankruptcy (in the case of an individual), this gives rise to a disposal in terms of paragraph 160M(3)(b) and subsection 160M(1). Similarly, the liquidation of a company also constitutes a release and thus a disposal. The debt is disposed of by the guarantor for no consideration. Paragraph 160ZD(2)(a) and subsection 160ZD(2A) operate to deem market value to be received by the

guarantor as if the disposal had not occurred. Whether a capital loss is incurred on the debt depends on the deemed market value of the debt at the time of disposal and on whether the debt is a personal-use asset.

43. If a guarantor recovers part of the debt from the principal debtor, the consideration in respect of the disposal of the debt is the amount recovered from the debtor. The payment made to the guarantor by the debtor, even though it may be made later, is an amount that falls within paragraph 160ZD(1)(a) because it is an amount of money that the guarantor 'has received or is entitled to receive as a result of or **in respect of** the disposal' of the debt (emphasis added).

44. Any capital loss is reduced by subsection 160ZH(11) if the guarantor is entitled to a contribution from co-guarantors: refer to the English High Court case of *Leisureking Ltd v. Cushing (Inspector of Taxes)* [1993] STC 46 where it was recognised that contribution by co-guarantors diminished the amount of loss relief available to the guarantor.

Subsection 51(1)

45. A payment by a guarantor is deductible under subsection 51(1) if the giving of the guarantee, the guarantor's payment under the guarantee and the incurring of the loss or outgoing are acts done in gaining or producing assessable income or in carrying on business for that purpose - provided the loss or outgoing is not of a capital, private or domestic nature. If the payment under the guarantee is not deductible under subsection 51(1), the guarantor needs to consider whether a capital loss is incurred. That is, whether the debt which came to be owed to the guarantor on payment under the guarantee is not a 'personal-use asset'.

Whether a capital loss is incurred on disposal of the debt owing to the guarantor

Subsection 160B(1) - personal-use asset

46. Once payment has been made, a capital loss arises under paragraph 160Z(1)(a) on a disposal by a guarantor of the right of indemnity as a debt, unless the debt is a 'personal-use asset' in terms of subparagraph (b)(ii) of the definition in subsection 160B(1). The effect of this provision, together with subsection 160Z(7) in respect of the disposal of a debt by the guarantor, is that:

(a) If the debt does not come to be owed to the guarantor in the course of the gaining or producing of income or the carrying on of a business - the debt is a 'personal-use asset'

and no capital loss is deemed to be incurred by the guarantor on its disposal for the purposes of Part IIIA.

(b) If the debt did come to be owed to the guarantor in the course of the gaining or producing of income or the carrying on of a business - the debt is not a 'personal-use asset' and any capital loss incurred on its disposal is not affected by subsection 160Z(7). Subsection 160ZK(1) provides, however, that the reduced cost base of the debt under subsection 160ZH(3) is reduced by any part of the consideration in respect of the acquisition of the debt that has been allowed or is allowable as a deduction to the guarantor.

47. The test of what is a 'personal-use asset' in terms of subparagraph (b)(ii) of the definition in subsection 160B(1) requires a finding that the debt came to be owed for a **primary purpose** other than that of gaining or producing income or in the carrying on of a business. Therefore, if the debt which came to be owed as a consequence of entering the contract of guarantee, was expected to promote and enhance the income-earning activity of the guarantor, or came to be owed in the carrying on of the business, the debt would **not** be a personal-use asset and a capital loss would be allowed.

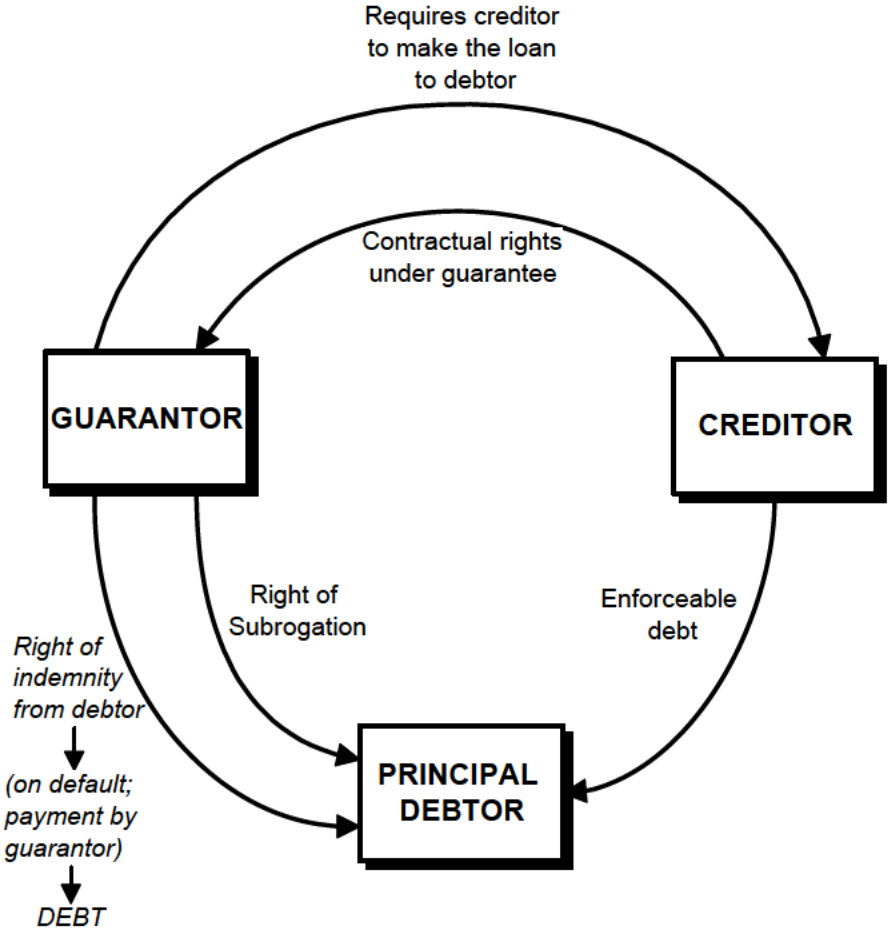
Date of effect

48. 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

General law

49. Under a simple scenario of a guaranteed loan agreement there are three parties. One is the principal debtor who borrows an amount of money. The second party is a creditor, usually a bank or financial institution which lends the money to the debtor. The third party is the guarantor who agrees that, if the debtor defaults on the loan, he or she will contribute a part or all of the debt owed to the creditor.



50. A contract of guarantee is a collateral contract to answer for the debt, default or miscarriage of another who is, or is contemplated to be or to become, liable to the person to whom the guarantee is given: *Sunbird Plaza* per Mason CJ (166 CLR 245 at 254; 77 ALR 205 at 207); *Re Conley; Ex parte The Trustee v. Barclays Bank, Ltd* [1938] 2 All ER 127 at 130-1; and see generally *Halsbury's Laws of Australia* vol 14, at 401,021, paragraphs 220-5.

51. A guarantee may be distinguished from an indemnity. An indemnity is a promise by a promisor to keep the promisee harmless against a particular loss as a result of entering into a transaction with a third party: *Total Oil Products (Aust) Pty v. Robinson* [1970] 1 NSWR 701 at 703; see *Halsbury's Laws of Australia* vol 14 at 401,021, paragraphs 220-1. The courts have emphasised the difference between the guarantor's secondary liability and the indemnifier's primary liability: *Sunbird Plaza* per Mason CJ (166 CLR 245 at 254; 77 ALR 205 at 207).

Principal debtor

52. A payment made under a guarantee does not give rise to any capital gains tax consequences for the principal debtor because that person does not own nor dispose of an asset.

53. This is similar to a creditor forgiving or waiving a principal debtor's debt. There are no capital gains tax consequences for the debtor (see Taxation Determination TD 3).

The creditor

54. The creditor's primary asset is the debt owed by the principal debtor. A debt is an 'asset' as defined in section 160A: see subparagraph (a)(ii) of the definition. If a person (principal debtor) creates a debt by borrowing money or obtaining credit from another person (creditor), the creditor is taken by subsection 160MA(1) to acquire the debt for the purposes of Part IIIA (although the person creating the debt (the debtor) is not deemed to have disposed of it) - i.e., neither subsection 160M(6) nor 160M(7) applies.

55. On entering into a guarantee contract, a creditor acquires a further asset being the contractual rights under the guarantee including the right to call on the guarantor for payment. A guarantee is a chose in action in the hands of the creditor: *Loxton v. Moir* (1914) 18 CLR 360. It is also an 'asset' as defined in section 160A: see subparagraph (a)(iii) of the definition. The guarantor undertakes to be answerable to the creditor for the debt, default or miscarriage of the principal debtor.

56. The creditor's contractual rights are, in terms of subsection 160M(6), created by the guarantor and are vested in the creditor. Subsections 160M(6A) and (6B) therefore apply. The combined effect of these provisions is that:

- paragraph 160M(6A)(a): the guarantor is taken to have acquired and to have commenced to own the contractual rights at the time specified in subparagraph 160U(6)(a)(ii), i.e., immediately before the contract of guarantee is made;
- paragraph 160M(6A)(b): the guarantor is later taken to have disposed of the asset to the creditor at the time specified in subparagraph 160U(6)(a)(iii), i.e., at the time of the making of the contract of guarantee;
- paragraph 160M(6A)(c): the guarantor is taken not to have paid or given any consideration in respect of the contractual rights, i.e., the appropriate cost base for the contractual rights (apart from incidental costs) is nil;
- paragraph 160M(6A)(d): the guarantor is not deemed to have received market value consideration for the disposal;

- paragraph 160M(6B)(a): the creditor is taken to have acquired the rights under the contract of guarantee from the guarantor, and to have commenced to own the contractual rights at the time specified in subparagraph 160U(6)(a)(i), i.e., at the time of the making of the contract of guarantee; and
- paragraph 160M(6B)(b): the creditor is not deemed to have paid market value consideration for the acquisition**.**

57. Accordingly, there are two assets owned by the creditor:

(a) the debt owed by the principal debtor; and

(b) the rights under the contract of guarantee, the main right being the ability to seek payment from the guarantor if the principal debtor defaults.

Consideration given by the creditor

58. The creditor's rights against the debtor and the guarantor are interdependent, in the sense that the creditor, at law, can demand recovery of the debt from either the debtor or the guarantor (on default) or partly from each: see Mason CJ in *Sunbird Plaza* 166 CLR 245 at 254-255; 77 ALR 205 at 208. But the creditor cannot recover any amount **in excess of** the loan moneys (including accrued interest, according to the terms of the guarantee), payment of which is guaranteed by the guarantor. The creditor can recover an amount outstanding on the principal debt, up to the amount of the loan, if the guarantor has guaranteed the whole of the principal debt: per Oliver LJ in *Barclays Bank Ltd v. TOSG Trust Fund Ltd* [1984] 1 All ER 628.

59. The creditor's relevant cost base for the debt is the amount of the debt. The consideration given by the creditor in respect of the acquisition of the contractual rights under the guarantee is the promise of the creditor to make a loan, or extend or maintain credit, to the debtor.

60. That the promise to make the advance to the principal debtor is the usual form of contractual consideration provided by the creditor is supported by authority: see Phillips and O'Donovan, *The Modern Contract of Guarantee* (2nd ed, Law Book Co, 1992) at 52 and cases cited therein (*Smith v. Passmore* (1883) 4 LR (NSW) 274; *S H Lock Discounts & Credits Pty Ltd v. Miles* [1963] VR 656).

61. The contractual promise may be viewed as 'consideration in respect of the acquisition of an asset' for the purposes of paragraph 160ZH(1)(a), (2)(a) or (3)(a) as defined in paragraph 160ZH(4)(b), being 'property other than money'. In *Case 5/93* 93 ATC 122 at 127-

129; *AAT Case 8493* (1993) 25 ATR 1027 at 1034-1035, Dr P Gerber determined that a right to enforce a promise not to sue constituted 'property other than money as a result of or in respect of the disposal' (of an asset) within the terms of paragraph 160ZD(1)(b).

62. The term 'property' is not defined for the purposes of either section 160ZH or 160ZD. Its possible meaning was discussed in the decisions of the Full Federal Court and the Full Bench of the High Court in *Hepples v. FC of T* 90 ATC 4497; (1990) 21 ATR 42 and 91 ATC 4808; (1991) 22 ATR 465 respectively, but only in the context of what constitutes 'an asset', as defined in the former section 160A to include 'any form of property'.

63. Gaudron J in *Hepples* held that the right of the appellant's employer and its associated companies to enforce the promise of the appellant was an 'asset' within the ordinary meaning of that word and as defined in section 160A (91 ATC at 4828; 22 ATR at 488).

64. Gummow J in *Hepples* referred to the definition in section 160A to the effect: '...in the absence of a contrary intention, " 'asset' means any form of property" and includes the subject matter of paragraph (a), (b) and (c). The expression "any form of property" is central to the definition...' (91 ATC at 4512; 21 ATR at 60). Aided by a general principle of construction, he observed that the expression 'any form of property' was not extended by the formulation 'means and includes' but rather the inclusion of paragraphs (a), (b) and (c) exhaustively explained the subject of the definition. Those paragraphs made it clear which assets Part IIIA is concerned with.

65. However, the expression 'property' in sections 160ZD and 160ZH is **not** so limited.

66. It should be noted that Gummow J held that the term 'all forms of incorporeal property' in the former paragraph (a) of section 160A (re-enacted in the present definition in paragraph (aa)) did not extend 'any form of property' to personal rights, such as an equity to have the Court rectify a written contract of personal services, or the right to maintain an action for recovery of unliquidated damages in tort for personal injury. Nor did it extend the definition to property which by virtue of statute cannot be effectively assigned, or the benefit of a contractual obligation where the identity of the person in whose favour the obligation is to be discharged is a matter of importance to the party on whom the obligation rests, as in a contract for personal services: (91 ATC at 4514; 21 ATR at 62).

67. We maintain that a promise given by A to B to lend money to C, such as the promise given by a creditor to a guarantor, is encompassed by none of the exclusions to the term 'all forms of incorporeal property' referred to by Gummow J.

68. The general term 'property' includes choses in action, being valuable things as well as tangible goods. They are a species of property, as distinct from corporeal goods, and encompass rights of personal action, debts, mortgages, shares, copyrights and patent rights: Williams' *Principles of the Law of Personal Property* (14th ed, London, Sweet and Maxwell, 1894) at 1-42; *Helmore's Personal Property and Mercantile Law in New South Wales*, W J Chappenden and J W Carter (9th ed, Law Book Co, 1985) at 3.

69. In *Loxton v. Muir* (supra), the High Court held that a guarantee debt, being a chose in action, was 'property' capable of assignment. Rich J determined that a right to sue for a sum of money was a chose in action and was a proprietary right (CLR at 379). See also *National Provincial Bank Limited v. Ainsworth* [1965] AC 1175 at 1247 per Lord Wilberforce; Mason J in *R v. Toohey and Another; Ex parte Meneling Station Proprietary Limited and Others* (1982) 158 CLR 327 at 342-344; 44 ALR 63 at 74-75.

70. It is arguable that if the benefit of a contractual obligation is technically capable of disposition, and is **not** one where the identity of the person in whose favour the obligation is to be discharged is a matter of importance to the party on whom the obligation rests, such a benefit is 'incorporeal property' and is 'property' for the purposes of paragraph 160ZH(4)(b) and paragraph 160ZD(1)(b). The explanatory memorandum to *Taxation Laws Amendment Bill (No 4) 1992* (Act 191 of 1992) confirms the view that property is generally regarded as something that is capable of assignment or transmission (at 65).

71. On the question of valuation of the contractual promise, it is doubtful that the guarantor would ever want to assign the benefit of the creditor's promise to make a loan to the debtor, simply because there is no market for it.

72. If a taxpayer has given, or is required to give, property other than money in respect of the acquisition of an asset, the consideration in respect of the acquisition of the asset is the market value of that property at the time of the acquisition: paragraph 160ZH(4)(b). Paragraph 160ZH(9)(b) deems the taxpayer to have paid or given as consideration in respect of the acquisition of an asset an amount equal to the market value of the asset at the time of acquisition, if the whole or any part of the consideration given by the taxpayer in respect of the acquisition of the asset cannot be valued.

73. We cannot envisage that a market value exists for such a promise, in the sense of a value determined by an open and unrestricted market of willing (but not anxious) informed, independent buyers and sellers. In *O'Brien (Inspector of Taxes) v. Benson's Hosiery (Holdings) Ltd* [1978] 3 All ER 1057, in relation to rights under an employment contract, the UK Court of Appeal determined

that 'there can be no market for what is unsaleable' (at 1063). As the creditor's promise to a guarantor to make a loan to a third party lacks the commercial character of transferability, although technically assignable (that is, assignable at law or in equity), we accept that the market value of the promise made to the guarantor is nil.

74. On this view, if the principal debtor defaults and the guarantor is called on to pay and does pay under the guarantee, there are offsetting gains and losses to the creditor. On default of the debtor, if the debt is disposed of by the creditor, for example, by way of release, there is a disposal under paragraph 160M(3)(b) and subsection 160M(1). The debt is acquired by the creditor for a cost base equal to the amount of the loan and a capital loss may arise on its disposal. If the creditor exercises his or her rights under the guarantee so that the guarantor is called on to pay (and does pay) under the guarantee, the guarantee rights are disposed of by way of discharge or satisfaction under paragraph 160M(3)(b), or the rights may otherwise be released by the creditor so as to amount to a disposal for paragraph 160M(3)(b). The contractual rights under the guarantee are acquired for nil consideration (see paragraph 73 above). A capital gain therefore accrues to the creditor on disposal of the guarantee rights, equal to the amount of payment made by the guarantor. The loss on the debt is reduced by the amount of the capital gain.

Alternative view

75. If, in the alternative, a contractual promise such as that given by the creditor as consideration for the acquisition of the rights under the guarantee is not 'property' for the purposes of paragraph 160ZH(4)(b), then the creditor has not given money or property, as consideration, for the purposes of paragraph 160ZH(4)(a) or paragraph 160ZH(4)(b). Paragraph 160ZH(9)(a) is excluded by paragraph 160M(6B)(b) from applying to the acquisition of the asset (the rights under the guarantee); therefore, the creditor is not deemed to have given any consideration in respect of the acquisition. Accordingly, on either view, the result is that there is a nil cost base to the creditor.

Recovery against both guarantor and debtor

76. If both the debtor and the guarantor (or co-guarantors) repay part of the debt owing to the creditor so that the debt is paid in full, the capital loss incurred on the disposal of the debt offsets the capital gain which accrues, to the extent of the payment under the guarantee.

77. The guarantor is absolutely discharged if the creditor, without having received full payment from the debtor, nevertheless agrees to discharge the debtor from any further liability: *Jowitt v. Callaghan*

(1938) 38 SR (NSW) 512 at 518; and see Phillips and O'Donovan (op cit at 249 and the cases cited at footnote 36). No capital gain accrues on the guarantee, which is disposed of for no consideration. The market value deeming rules in paragraph 160ZD(2)(a) and subsection 160ZD(2A) apply to deem market value consideration to be received by the creditor. The rights are valued at the time of disposal, as if the disposal had not occurred and was never proposed to occur. Because the debt ceases to exist, market value of the right to call on the guarantor for payment is nil.

78. To the extent that there is a shortfall between loan principal outlaid and the amount the creditor recovers from the debtor and the guarantor, that shortfall is attributed to the primary asset (being the debt). The debtor undertakes to perform the principal obligation to repay; the guarantor's liability is secondary and is contingent on the default of the debtor (see O'Donovan and Phillips, at 19-20; also Mason CJ in *Sunbird Plaza* (166 CLR 245 at 247; 77 ALR 205 at 207).

79. The capital loss incurred on the disposal of the debt is offset, in part, to the extent that payment is recovered from the guarantor.

How are the creditor's assets disposed of?

If the principal debtor pays the debt

80. If the principal debtor pays the debt, it is disposed of in terms of paragraph 160M(3)(b) and subsection 160M(1) by satisfaction. At the same time, the other asset (being the rights under the guarantee) is also disposed of in terms of paragraph 160M(3)(b) and subsection 160M(1) as a release of a chose in action or any other right.

If the creditor forgives the debt

81. The debt is disposed of - see Taxation Determination TD 2. The disposal is for market value by paragraph 160ZD(2)(a) and subsection 160ZD(2A). The contractual rights are disposed of in terms of paragraph 160M(3)(b) and subsection 160M(1) by way of release. The rights under the guarantee are deemed (by paragraph 160M(3)(b) and subsection 160M(1)) to be disposed of by release.

If the principal debtor defaults and the guarantor is called on to pay

82. On payment by the guarantor of the debt, it ceases to exist and the creditor is deemed to have disposed of the debt by way of release (see paragraph 160M(3)(b) and subsection 160M(1)). There is a

disposal of the contractual rights under the guarantee by satisfaction in terms of paragraph 160M(3)(b) and subsection 160M(1).

If both the principal debtor and the guarantor default

83. The debt and the right to call on the guarantor for payment are disposed of in terms of paragraph 160M(3)(b) and subsection 160M(1) by release when the creditor releases the parties from their obligations.

The guarantor

Effect of guarantor making payment to the creditor

84. In summary, when the guarantor makes a payment to the creditor under the guarantee, assuming the principal debtor's liability is **extinguished in full**, the effects are:

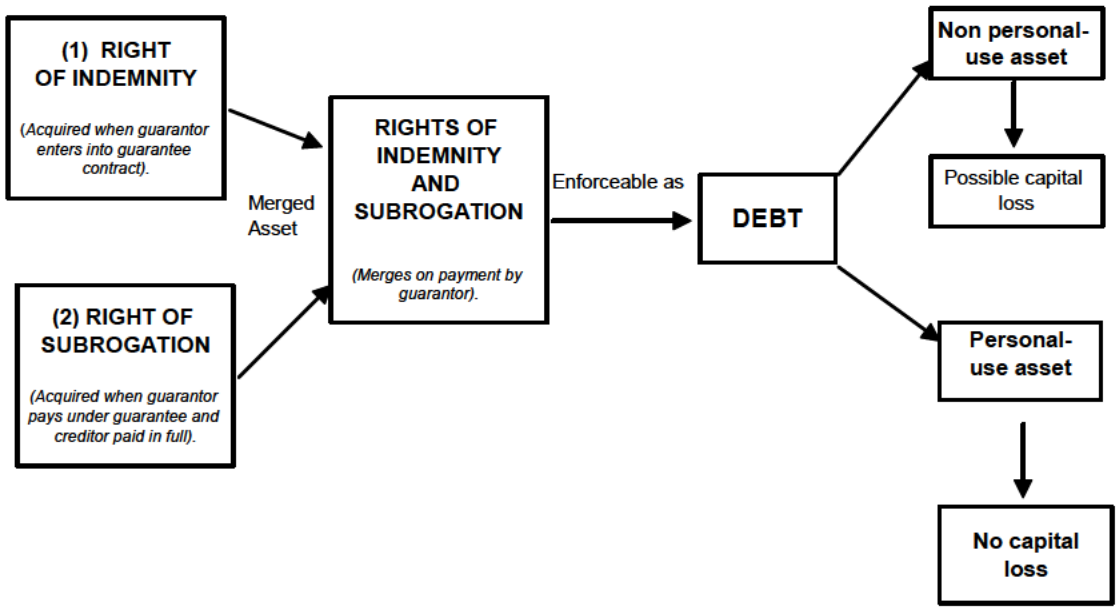
- the creditor's debt is disposed of;
- the guarantor's right of indemnity against the debtor becomes an enforceable debt; and
- the guarantor acquires a right of subrogation under equitable principles or under statute.

85. The assets which the guarantor has are therefore:

- a right of indemnity which is enforceable on payment by the guarantor; and
- a right of subrogation.

86. As mentioned earlier, we consider that for Part IIIA purposes, when the guarantor is subrogated to the rights of the creditor, the guarantor's right of indemnity is, in effect, merged (without there being any disposal) with the guarantor's subrogation rights. The right of indemnity and the right of subrogation become coextensive (see paragraph 35 above).

87. Given the inter-relationship between the guarantor's assets, it is simpler to discuss the capital gains tax implications for each in the chronological sequence in which the transactions under a guarantee occur, rather than to analyse each asset independently of the other.



Acquisition of the guarantor's assets

Right of indemnity

88. The principal remedy of a guarantor against a principal debtor is an indemnity. The right of the guarantor to be indemnified by the principal debtor for the amount paid under a contract of guarantee may arise by express agreement. In the absence of express agreement, the courts will imply a right to be indemnified as a term of the contract of guarantee if it is a tri-partite agreement. Otherwise, the right arises under an implied contract of indemnity or on equitable principles: *Israel v. Foreshore Properties Pty Ltd (in liq)* (1980) 54 ALJR 421 at 423-424 per Aickin J, with whom Gibbs CJ, Stephen, Murphy and Wilson JJ agreed. See also *Re a Debtor* [1937] Ch 156; *Anson v. Anson* [1953] 1 QB 636; *McColl's Wholesale Pty Limited v. State Bank of New South Wales and Others* [1984] 3 NSWLR 365 and Purvis J in *Case 23/95* 95 ATC 249; *AAT Case 10,116* (1995) 30 ATR 1269.

Right of subrogation

89. The right of subrogation is codified and given statutory recognition and force in all States: see *Halsbury's Laws of Australia*, vol 14 at 401,326-7, paragraphs 220-300. Previously, the right of subrogation was governed by equitable principles. A guarantor is

entitled on payment of the guaranteed debt to be subrogated to the creditor's rights against the principal debtor. The guarantor's right of subrogation is a right both to enforce and to have the benefit of the creditor's rights and to have those rights maintained before their exercise.

90. A right of subrogation is enforceable only when the creditor's debt has been paid **in full**, notwithstanding that the contract of guarantee is for an amount less than the total amount of the debt owing by the principal debtor to the creditor: *Duncan, Fox & Co v. North and South Wales Bank* (1880) 6 App Cas 1; *Dixon v. Steel* [1901] 2 Ch 602 at 607.

91. On equitable principles, it is not necessary for the guarantor claiming the right of subrogation to have paid the whole of the principal debt himself or herself (e.g., the guarantee might be for an amount less than the total amount of the debt); subrogation is available even if part of the debt was paid by the principal debtor or another guarantor: *A E Goodwin Ltd v. A G Healing Ltd* (1979) 7 ACLR 481 at 487-8.

92. If the guarantees are joint and several, the guarantor is liable to pay the full amount of the debt of the principal debtor. If **the guarantor** pays the debt in full, a statutory right of subrogation arises (see section 3 of the *Law Reform (Miscellaneous Provisions) Act 1965* (NSW) and equivalent State statutes). Under that section, the guarantor acquires a right of subrogation against co-sureties, which may not be exercised if the co-sureties are themselves insolvent and have not met their liabilities under the contract of guarantee.

93. There is no right of subrogation unless the guarantor's right of indemnity from the principal debtor existed at the date of payment of the principal debt by the guarantor, or immediately thereafter: *Scholefield Goodman and Sons Ltd v. Zyngier* [1984] VR 445.

Whether the rights of indemnity and subrogation are assets for Part IIIA purposes

94. We consider that, both before and after the *Taxation Laws Amendment (No 4) Act 1992* extended the definition of 'asset' in section 160A, effective from 26 June 1992, a guarantor's rights of indemnity and subrogation are 'assets' as defined for Part IIIA purposes.

95. A guarantor's rights of indemnity and subrogation, we consider, are proprietary rights capable in their nature of assumption by third parties (see paragraph 69 above). A right to sue, in the event of a breach of a contractual obligation, to compel performance of the obligation was regarded by the Federal Court of Australia (Spender J) in *Unilever Australia Securities Ltd v. FC of T* 94 ATC 4388 at

4397-8; (1994) 28 ATR 422 at 433-434 as a proprietary right. His Honour took the view that the fact that the right was assignable only with the consent of all other parties did not mean that it was not a right capable in its nature of assumption by third parties. We consider that the same can be said of a guarantor's rights of indemnity and subrogation.

Time of acquisition of rights of indemnity and subrogation at general law

96. A guarantor's right of indemnity is either an equitable right, or a contractual right (express or implied) which is acquired when the contract of guarantee is entered into (or, alternatively, when the debtor requests a person to act as guarantor).

97. In *Re A Debtor* [1937] 1 All ER 1, Slessor LJ in the Court of Appeal referred to the decision of Parker J in *Re Mitchell; Freelove v. Mitchell* [1913] 1 Ch 201; [1911-13] All ER 187 who said (1 Ch at 206; All ER Rep at 189):

> 'Until the surety is called upon to pay and does pay something under his guarantee, there is no debt or right at law at all; until then, a surety's right is confined to a right to come into equity in order to get an indemnity against his liability to the creditor.'

98. Slessor LJ says on this point (1 All ER at 6):

> 'Although no question arises that there is **no enforceable debt** at law which can be enforced by the surety until the surety, being liable and obliged to pay, does pay the creditor ... it by no means follows that the obligation of the principal does not in appropriate circumstances arise by an implied agreement at the time of the giving of the guarantee that the principal, if and when the guarantor is called upon to pay, will indemnify the guarantor, though the event which gives rise to the enforceability of the promise falls later...
>
> In the present case, the implied undertaking of the principal debtor to repay the money paid on his behalf to the creditor arose at the time of the guarantee.' (emphasis added)

On payment by the guarantor, the right of indemnity becomes an enforceable debt

99. The right of indemnity is, before payment by the guarantor, subject to a contingency, namely, the default of the debtor and a request for payment by the creditor. There is no debt due to the guarantor before the guarantor's payment: see Parker J in *Re Mitchell* (supra).

100. Under general law, the right of indemnity becomes an enforceable debt on payment. The Court of Appeal in *Re A Debtor* 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 on to pay, and does pay, the creditor under the guarantee. Greene LJ further commented in agreement (1 All ER at 8):

> 'The implied undertaking to indemnify is an undertaking to reimburse 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.'

Further support is found in *Page v. Ireland* (unreported, NSW Supreme Court, 13 February 1991). See also *Halsbury's Laws of Australia*, vol 14 at 401,321-2, paragraphs 220-285.

101. The guarantor has a right to be indemnified by the principal debtor to the extent of the amount **paid** under their contract of suretyship: *A E Goodwin Ltd v. A G Healing Ltd* (1979) 7 ACLR 481 at 487 and 491.

102. Other features of the debt relationship are that the guarantor is entitled to prove in the bankruptcy of the principal debtor to that extent: *Barclays Bank Ltd and Others v. TOSG Trust Fund Ltd and Others* [1984] 1 All ER 628 at 641; *Westpac Banking Corporation v. Gollin and Co Ltd (in liq)* [1988] VR 397 at 405. Also, as a creditor of the principal debtor, the guarantor has the general rights of a creditor, including, for example, the right to sue on indemnity and, in the case of a corporate debtor, the right to apply for a winding-up: see *Halsbury's Laws of Australia*, vol 14 at 401,321-2, paragraphs 220-285.

Time of acquisition of rights of indemnity and subrogation under Part IIIA

103. Subsection 160M(6) and section 160U apply to the time of acquisition of the guarantor's right of indemnity.

Position of principal debtor

104. The principal debtor, in requesting the guarantor to undertake an obligation to pay the creditor on the principal debtor's behalf, creates a right of indemnity in favour of the guarantor.

105. The principal debtor, in terms of paragraph 160M(6)(a), creates an asset that is not a form of corporeal property and, on its creation, the asset is vested, in terms of paragraph 160M(6)(b) in another person (the guarantor).

106. By paragraph 160M(6A)(a), the principal debtor, as the person creating the asset, is taken to have acquired the right of indemnity at the time applicable under subparagraph 160U(6)(a)(ii), that is, immediately before the time of making of the contract of guarantee or the implied contract of indemnity, as the case may be.

107. By paragraph 160M(6A)(b), the principal debtor is later taken to have disposed of the right of indemnity to the guarantor at the time applicable under subparagraph 160U(6)(a)(iii), that is, at the time of making of the contract of guarantee or the implied contract of indemnity, as the case may be.

108. By paragraph 160M(6A)(c), the principal debtor is taken not to have paid or given any consideration, or incurred any costs or expenditure in respect of the right of indemnity (except for incidental costs), and by paragraph 160M(6A)(d), paragraph 160ZD(2)(a) does not apply to the disposal.

Position of guarantor

109. By paragraph 160M(6B)(a), the guarantor is taken to have acquired the right of indemnity at the time applicable under subparagraph 160U(6)(a)(i), that is, at the time of making of the contract.

110. By paragraph 160M(6B)(b), paragraph 160ZH(9)(a) does not apply to the acquisition of the asset.

111. As to the time of acquisition of the guarantor's right of subrogation for Part IIIA purposes, it is when the guarantor pays the creditor the guaranteed amount (and the debt is paid in full): see subsection 160U(4).

112. If the guarantor is called on to pay under the guarantee, the guarantor is taken (by paragraphs 160M(6B)(a) and 160M(6B)(b)) to acquire the right of indemnity (disregarding incidental costs incurred) for a cost base equal to the amount the guarantor is obliged to pay under the guarantee. That is, the consideration the guarantor pays, or is required to pay, 'in respect of' the acquisition of the right of indemnity in terms of paragraph 160ZH(1)(a), (2)(a), (3)(a) or (4)(a).

113. At general law, the right of subrogation is not severable from the right of indemnity and it is merely a means of enforcing the right of indemnity. We consider that for Part IIIA purposes when the guarantor is subrogated to the rights of the creditor, the guarantor's right of subrogation is in effect subsumed by, or merged into, (without there being any disposal) the guarantor's right of indemnity (see paragraph 35 above).

114. The extent to which the guarantor can recover from the principal debtor is limited to the amount that the guarantor has paid under the

guarantee: see Mason CJ in *Sunbird Plaza* at CLR 247; ALR 207. Therefore, the cost base of the merged or transformed asset is the amount of the payment under the guarantee; it cannot exceed the (notional) amount paid or given for the original asset.

Alternative view

115. In the UK decision of *Clevelys Investment Trust Co v. Commissioners of Inland Revenue* [1975] STC 457, a taxpayer holding company guaranteed the overdraft indebtedness of its subsidiary to the subsidiary's bank. When the subsidiary went into liquidation, the company paid out the debt as guarantor. The four Lords sitting in the Scottish Court of Session had to determine whether the sum was paid out 'wholly and exclusively' in consideration for the acquisition of the right of subrogation against the subsidiary (which was worthless as the subsidiary was in liquidation, as would often be the case, thus giving rise for the opportunity of claiming a capital loss).

116. The Lords unanimously held that the main object of the payment of the moneys to the bank was the discharge of the taxpayer's obligation to the bank under the guarantee, and the taxpayer's acquisition of the bank's claim was no more than an ancillary or incidental consequence of achieving the main object. The payment could not be regarded as merely an ancillary step towards the acquisition of the bank's claim against the subsidiary. Accordingly, no capital loss was allowed.

117. Doubt has been cast on the soundness of this decision as authority in Australia: see Lehmann and Coleman, *Taxation Law in Australia*, 3rd ed at 231 and D G Cominos, *Taxation in Australia*, November 1986 at 321.

Disposal of the debt acquired by the guarantor under the right of indemnity (once the right of indemnity is enforceable)

118. The debt which arises under the right of indemnity, once payment has been made under the guarantee, can be disposed of in a number of ways, most of which may or may not give rise to a capital loss: refer to the Tables at paragraph 169 below.

119. Disposal of the debt can occur in any of the following ways:

(a) The principal debtor pays the debt to the guarantor - no capital loss.

(b) There may be no likelihood of payment by the principal debtor - the guarantor must take some action in terms of paragraph 160M(3)(b) in order to dispose of the debt.

A capital loss may arise, depending on whether the debt is a personal-use asset.

(c) The debt is forgiven at law (or in equity) by the guarantor - a formal deed of forgiveness is required for this - a capital loss may result in this situation (see generally Taxation Determination TD 2 in relation to debt forgiveness). If a guarantor forgives the debt, or waives the obligation, so as to amount to an effective disposal, the debt is disposed of by way of surrender, release or abandonment in terms of paragraph 160M(3)(b) and subsection 160M(1).

Paragraph 160ZD(2)(a) deems the guarantor to have received as consideration on disposal an amount equal to the market value of the asset. Because the asset was not disposed of to another person, subsection 160ZD(2A) operates to deem the market value, for the purposes of subsection 160ZD(2), to be the market value of the asset at the time of the disposal as if that disposal had not occurred. The waiver of a debt is addressed in Taxation Determination TD 2; the market value of the right at the time of its disposal is worked out as though the debt were not waived. Whether a capital loss is incurred on the debt depends on the deemed market value of the debt: paragraph 160ZD(2)(a) and subsection 160ZD(2A); and on whether the debt is a personal-use asset.

(d) A Limitations Act could bar recovery of the debt - then the right to recovery expires. The debt continues to exist but it cannot be enforced. There is no disposal within terms of paragraph 160M(3)(b) and it cannot, therefore, give rise to a capital loss. If a Limitations Act deems the actual debt to be expired, a disposal will occur. Subsection 160ZD(2B) avoids the operation of the market value deeming rules in subsection 160ZD(2) and a capital loss would arise.

(e) The principal debtor could be discharged from bankruptcy (in the case of an individual) - this will give rise to a disposal in terms of paragraph 160M(3)(b) and subsection 160M(1); similarly, the liquidation of a company will also constitute a release and disposal. A capital loss may arise, depending on whether the debt is a personal-use asset. Interim distributions may not constitute the whole amount of consideration in respect of disposal. Note paragraph 160ZD(1)(a) refers to an amount that the taxpayer 'has received or is entitled to receive ... **as a result of or in respect of** the disposal' of an asset. (emphasis added)

Assignment of the right of indemnity

120. If the right of indemnity is assigned for value, or otherwise disposed of, a capital gain may arise. The capital gain is determined in accordance with paragraph 160Z(1)(a) or a capital loss may be incurred under paragraph 160Z(1)(b).

121. The right of indemnity and the associated right of subrogation can be disposed of by the guarantor exercising the rights, or by assigning them; or by abandoning or releasing them (paragraph 160M(3)(b)), which is how disposal of these rights would be effected if the debt acquired by the guarantor was forgiven. The right of subrogation cannot be alienated separately from the right of indemnity. Depending on the value of the right of indemnity at the time of disposal, or of the merged asset where a right of subrogation is acquired, a capital loss can arise on disposal.

122. If a guarantor assigns the right of indemnity **before** paying a creditor under the guarantee, the guarantor no longer has any recourse against the principal debtor. In this case, the guarantor has not paid, or is not required to pay, an amount 'in respect of' the acquisition of the right of indemnity. The market value rules of paragraph 160ZH(9)(a) are excluded by paragraph 160M(6B)(b). The right of indemnity does not become a debt enforceable against the debtor at the suit of the guarantor. No right of subrogation arises if the right of indemnity has been assigned before payment by the guarantor (see paragraph 93 above) and a claim against the principal debtor cannot be enforced.

123. A capital loss is reduced by subsection 160ZH(11) if the guarantor is entitled to a contribution by co-guarantors: see *Leisureking Ltd v. Cushing* [1993] STC 46.

Subsection 51(1)

If creditor seeks payment from guarantor rather than debtor

124. A payment by a guarantor is deductible under subsection 51(1) if the giving of the guarantee, the guarantor's payment under the guarantee and the incurring of the loss or outgoing are acts done in gaining or producing assessable income or in carrying on business for that purpose - provided the loss or outgoing is not of a capital, private or domestic nature. In essence, the loss or outgoing must bear the character of an income producing expense or a working expense of a business.

125. If a guarantor is engaged in a business of giving guarantees for reward, a loss or outgoing arising on a failure by a principal debtor to

pay the guarantor is more likely to bear the requisite character to be deductible under subsection 51(1).

Company and subsidiary

126. The Courts have, on occasions, been reluctant to accept that there is any general proposition that a payment under a guarantee given by a parent company in respect of liabilities of any subsidiary can be regarded as necessarily incurred in its business and so deductible in terms of subsection 51(1). (Refer: *Hooker Rex Pty Limited v. FC of T* 88 ATC 4392; (1988) 19 ATR 1241 (*Hooker Rex)* per Sweeney and Gummow JJ at ATC 4403; ATR 1253 followed in *Case V115* 88 ATC 733; *AAT Case 4501* (1988) 19 ATR 3697.) However, if a company is able to satisfy the tests of deductibility set out by the Full Federal Court in the case of *FC of T v. Total Holdings (Aust) Pty Ltd* 79 ATC 4279; (1979) 9 ATR 885 (*Total Holdings*), then payments under a guarantee are characterised as part of the business activities of the company. However, even when they are so characterised they will very often be found not to be deductible on the ground that they are on capital account - see below.

127. In *Total Holdings*, it was held that interest on moneys borrowed by a company (the taxpayer) from its parent and on-lent interest-free to its subsidiary (TAL) was deductible. Lockhart J (with whom Northrop and Fisher JJ concurred) expressed the principle applying in that case as follows:

> 'The activities of the taxpayer were designed to render TAL profitable as soon as commercially feasible and to promote the generation of income by TAL and its subsequent derivation by the taxpayer and thence [its parent].
>
> In my opinion the liability for interest of the taxpayer to [its parent] was incidental and relevant to the derivation of its income and was part of its business activities. The payment of interest satisfied the tests required in respect of each limb of sec. 51' (at ATC 4286; ATR 893).

128. In Taxation Ruling IT 2606, the view was expressed that where the facts of a case are substantially similar to those in *Total Holdings*, a deduction for interest is allowable under subsection 51(1). In paragraphs 20 and 21 of IT 2606 it is noted that the holding company needs to show an expectation and intention as well as the potential for dividends to be paid to it. This necessarily requires 'sufficient control over the subsidiary to ensure that this policy was followed'.

129. A case in which the principle of *Total Holdings* did not apply is *Hooker Rex*. In *Hooker Rex*, the taxpayer relied on evidence that it had given a number of guarantees in the course of its business, so that liabilities incurred under guarantees given by the taxpayer should be

regarded as necessarily incurred in its business. The evidence disclosed that some of those guarantees were given in support of the development of land owned by subsidiaries of the taxpayer.

130. In that case, a payment was made under an undertaking given by the taxpayer to the Commissioner of Taxation to pay any income tax found to be payable by one of its subsidiaries to the extent that such tax was not paid by the subsidiary or its liquidator. In exchange for the undertaking, the Commissioner consented to the liquidation of the subsidiary and the transfer of its assets to its parent. The payment did not satisfy the positive limbs of subsection 51(1) as the outgoing lacked the required connection with the gaining or producing by the taxpayer of its assessable income or the carrying on by the taxpayer of its business for that purpose.

131. Sweeney and Gummow JJ characterised the outgoing under the guarantee as being on capital account (at ATC 4404; ATR 1253):

> 'The giving of the guarantee thus was a step in a process which led to an increase in the asset backing of, and, other things being equal, the value of, the shares held by the taxpayer in Shangri-la. Accordingly, the outgoing was on capital account. Similarly, the loan by the taxpayer to the subsidiary in *F.C. of T. v. Total Holdings (Australia) Pty. Ltd. (supra)*, was presumably of a capital nature: See Parsons, *Income Taxation in Australia* [§6-245].'

132. The decision in *Hooker Rex* is one that turns on the particular facts of that case. While the decision in *Total Holdings* was considered in the *Hooker Rex* case, the majority found that decision offered no 'immediate support' for the taxpayer in the case before them (at ATC 4403; ATR 1253).

133. A slight variation to a company guaranteeing the debts of a subsidiary is the case of a parent company guaranteeing an overdraft facility of a customer of its subsidiary companies in the expectation that the customer will continue to trade with the subsidiary companies. In (1969) 15 CTBR (NS) *Case 33*, the majority of Taxation Board of Review No 2 found that there was a genuine commercial relationship between the giving of the guarantee to a customer of the subsidiary companies and the gaining of the taxpayer parent company's own income. The guarantee, while it did not directly produce income, did encourage the sale of the group's goods, it encouraged comity with the taxpayer's lessee and it was a transaction expected of the taxpayer. Moreover, the loss was held **not** to be a loss of capital. It was a regular and normal incident of the taxpayer's income earning activities (at 218) and, so, deductible under subsection 51(1).

134. Deductions have been allowed by the former Boards of Review if a guarantee is given to support customer obligations in the course of trading activities (refer (1953) 4 CTBR (NS) *Case 57*).

Shareholder

135. The principle in *Total Holdings* might be considered to apply to a shareholder who guarantees the debts of the company in which he/she holds shares. This principle would then be sufficient to allow one of the two positive limbs of subsection 51(1) to be satisfied. However, a deduction may be denied because the expenditure is found to be on capital account. As the majority in *Hooker Rex* determined, a guarantee is akin to loan capital: see paragraph 131 above.

136. Reference may be made, therefore, to a line of decisions of the Administrative Appeals Tribunal and the former Boards of Review which accepts that payments made under guarantees by shareholders or directors are not deductible under subsection 51(1): see *Case V115* 88 ATC 733; AAT *Case 4501* (1988) 19 ATR 3697; *Case V117* 88 ATC 741; AAT *Case 4503* (1988) 19 ATR 3708; *Case 56/95* 95 ATC 459; AAT *Case 10,518* (1995) 31 ATR 1322; also (1979) 23 CTBR (NS) *Case 9* (Taxation Board of Review No 2). In a typical case, reported as *Case V115*, Senior Member P J Roach did not allow a deduction under subsection 51(1) for payment made by the taxpayer who was a director and shareholder of a land development company and who was a creditor of the company under a guarantee given by the taxpayer in respect of the company's liabilities.

137. Liabilities arising under contracts of guarantee will not be deductible under subsection 51(1) if the provision of guarantees and the losses or outgoings arising under the guarantees are not regular and normal incidents of the taxpayer's earning activities. In *Case Q39* 83 ATC 171 at 173; (1983) 26 CTBR (NS) *Case 103* at 694, Mr K P Brady, Chairman, referred to a line of Board cases stretching from 1946 which concluded that payments under guarantees are capital.

138. It seems that only if a taxpayer acts as guarantor to such a degree as to amount to his or her usual practice, say, as a solicitor, in the ordinary course of business will the payments be deductible as a revenue outgoing and not of a capital nature. (Refer *Jennings (Inspector of Taxes) v. Barfield & Barfield* [1962] 2 All ER 957; 40 TC 365.)

Deductibility of guarantee payments if the guarantor receives a fee

139. If a fee is received by a guarantor, usually from the debtor, for guaranteeing a debt, the amount is generally received in the course of gaining or producing income, if not in relation to the carrying on of a business. However, any amount paid out under a guarantee is not deductible merely because the first positive limb of subsection 51(1) is satisfied. The payment may be characterised as a capital payment and thus not deductible.

Personal-use asset

140. The availability of a deduction under subsection 51(1) for payments made by a guarantor must be determined having regard to the positive limbs of that subsection and the capital exclusion in that subsection. If no deduction is available, it is necessary to determine whether a capital loss is available on disposal of the debt owed to the guarantor by the principal debtor. To restate, the debt is the right of the guarantor to an indemnity against the principal debtor which is a debt that arises on the making of the payment by the guarantor to the creditor under the guarantee. Accordingly, a loss on disposal of such a debt would generally be capital in nature and not deductible under subsection 51(1). However, a loss on disposal of the debt would be allowable under Part IIIA if the debt was not a 'personal-use asset'.

141. If a debt is a personal-use asset, it is a non-listed personal-use asset. The significance of this is that under subsection 160Z(7), the disposal of a non-listed personal-use asset cannot give rise to a capital loss.

142. Paragraph (a) of the definition of 'personal-use asset' in subsection 160B(1) defines personal-use assets broadly as those owned by a taxpayer and used or kept primarily for the personal use or enjoyment of the taxpayer or associates of the taxpayer.

143. Subparagraph (b)(ii) of the definition of 'personal-use asset' in subsection 160B(1) extends the definition in paragraph (a) to a debt owed to a taxpayer which specifically:

> '...came to be owed otherwise than in the course of:
>
> - the gaining or producing of income by the taxpayer;
>
> or
>
> - the carrying on of a business by the taxpayer...'

The explanatory memorandum states (at 22):

> '...In short the subparagraph applies to debts of a private or domestic nature.'

Accordingly, subparagraph (b)(ii) is merely an extension of the definition in paragraph (a) of 'personal-use asset'. The definition extends to options and debts in respect of such assets, as two classes of assets which might not otherwise be regarded as personal-use assets.

144. To fall within subparagraph (b)(ii) of the definition in subsection 160B(1) requires the existence of a debt. Payment by a guarantor under a guarantee creates an enforceable debt against the principal debtor (refer paragraphs 37 and 140 above).

145. The test of whether the debt 'came to be owed' otherwise than in the course of gaining or producing income, or in carrying on business, is to be applied at the time the guarantor entered into the guarantee, which is the genesis of the debt. To apply the test at that time, rather than when a guarantor pays the creditor under a guarantee, is more favourable to taxpayers because:

(a) the debtor is more likely to be solvent then (and therefore, there would have been a nexus to income); and

(b) a connection with the gaining of income or carrying on business is more likely to be established at that time.

Although the debt owing under the right of indemnity does not crystallise until payment by the guarantor, the acquisition of the debt is to be viewed as part of a chain of events and part of a series of amounts passing between the parties to a business venture (as observed by Deputy President McMahon in *Case W26* 89 ATC 273 at 278; *AAT Case 4955* (1989) 20 ATR 3357 at 3363, in relation to a guarantee fee).

146. Determining how a debt came to be owed involves an objective purpose test, by examining the surrounding circumstances at the time of entering into the guarantee. That test of what is a 'personal-use asset' in subparagraph (b)(ii) of the definition in subsection 160B(1) requires a finding that the debt came to be owed to the taxpayer for a primary purpose other than that of gaining or producing income or in the carrying on of a business. This interpretation accords with the language of paragraph (a) of the definition in subsection 160B(1) where the 'primary' purpose of an asset is adopted. Therefore, if the debt which came to be owed as a consequence of entering the contract of guarantee, was expected to promote and enhance the income-earning activity of the guarantor, the debt would **not** be a personal-use asset and a capital loss would be allowed.

147. A contrary result would arise if the debt of a family company or trust, in respect of the acquisition of the family's private residence, is guaranteed by a guarantor who also resided in that family residence. If the primary purpose of guaranteeing the debt was to benefit the guarantor and his/her family with a place to reside rather than to gain or produce income, the debt would be a personal-use asset and a capital loss would not be allowed.

148. Common situations where guarantees may be given which could raise the question whether the debt owed to the guarantor by the debtor was a personal-use asset include:

(a) a family member or relative guarantees the debt of another family member or relative, e.g., a father guarantees a loan for a daughter's purchase of a car;

(b) (i) a holding company acts as guarantor for the debts of a wholly-owned subsidiary which is committed to producing income and paying dividends to its parent;

(ii) cross-guarantees given in respect of subsidiary companies;

(c) an individual as a shareholder of a private company guarantees the debts of the company.

149. In situation (a), the guarantor's debt is clearly a personal-use asset because the debt did not come to be owed in the course of producing income by the family member or relative. The disposal of the debt, therefore, cannot give rise to a capital loss.

150. In situation (b)(i), the debt will generally be viewed as a debt which has come to be owed in the course of gaining or producing assessable income (such as expected dividend distributions) or in the course of carrying on a business by the guarantor. As a consequence, a debt arising under situation (b)(i) will not fall within subparagraph 160B(1)(b)(ii).

151. A wide view of what constitutes 'in the course of carrying on business' was adopted by Hill J in *FC of T v. Cooling* 90 ATC 4472 at 4479; (1990) 21 ATR 13 at 21. Where a taxpayer carries on a business, his Honour stated that it will often be necessary to make a 'wide survey' and 'an exact scrutiny of' a taxpayer's activities to determine whether a particular profit derives from the business operation of the taxpayer. He viewed the scope of the business widely, in stating that 'where a taxpayer operates from leased premises, the move from one premises to another and the leasing of the premises occupied are acts of the taxpayer in the course of its business activity just as much as the trading activities that give rise more directly to the taxpayer's assessable income' (at ATC 4484; ATR 26). Accordingly, a debt that came to be owed to a holding company on payment under a guarantee, in respect of guaranteed principal debts of a subsidiary (over which the parent had sufficient control to ensure a flow of dividends) can, in many cases, be viewed as an ordinary incident of the business activity of the holding company.

152. However, in situation (b)(ii) where there are cross-guarantees between subsidiaries in a corporate group, it may be more difficult for a debt that came to be owed to a subsidiary (as a guarantor) under such a cross-guarantee to satisfy the income test as opposed to the business test in subparagraph 160B(1)(b)(ii). Consider, for instance, a group comprising a holding company and two subsidiaries both of which are wholly owned directly by the holding company. In such a group, a debt that came to be owed to a subsidiary (as guarantor) under a cross-guarantee would not satisfy the income test if the guarantor subsidiary could not expect to receive income from the

sibling company. In that situation, the guarantor subsidiary would have to rely on the business test which would be satisfied if the debt came to be owed to the guarantor in the carrying on of its business.

153. If the giving of the guarantee is not for the benefit of the company as a whole then the debt may not have come to be owed in carrying on its business. While it depends on the facts of each case, it may be useful to consider examples where a parent company requires cross-guarantees between subsidiaries. Firstly, in the case where all the subsidiaries are equally credit worthy, it would be unlikely that the debt would have come to be owed otherwise than in the carrying on of the business of the guarantor. For example, cheaper finance may be obtained for the group by the giving of the cross-guarantees, and the burden of the risk undertaken by the guarantors may be proportionate to the likely advantage of cheaper finance to be obtained by each subsidiary giving the cross-guarantee. Alternatively, if a profitable subsidiary gives a cross-guarantee in respect of the debt of a sibling company operating a very marginal enterprise with a high debt/equity ratio, it is less likely that the debt would have come to be owed in the course of carrying on a business. Finally, if a subsidiary supplying goods to another subsidiary, guarantees the liabilities of that subsidiary, there is a direct benefit to the income-earning activities of the guarantor company. In these circumstances, the debt under the guarantee is likely to have come to be owed in the gaining or producing of income.

154. Situation (c) (individuals as shareholders) will not come within subparagraph 160B(1)(b)(ii) if the debt did not come to be owed otherwise than in the course of gaining or producing income or in carrying on the business of the taxpayer. The debt owing by the company to the guaranteeing shareholder arises when the shareholder meets his or her liability under the guarantee. If the purpose of the shareholder, objectively determined, in guaranteeing the company's debts was to assist the company to continue in business, and thus, to earn profits and to distribute dividends to shareholders, the debt would not be a personal-use asset. *Total Holdings* would provide some support for that conclusion.

155. Whether or not a shareholder can be said to have entered into a guarantee of the company's liabilities in order to assist the company in earning profits to be distributed in due course as dividends to (*inter alia*) the shareholder will be a question to be answered by a careful consideration of the overt facts and circumstances (*Magna Alloys & Research Pty Ltd v. FC of T* 80 ATC 4542; (1980) 11 ATR 276.) If the amount of a dividend which the shareholder could expect to receive was completely disproportionate to the amount of his/her liability under the guarantee there would be a *prima facie* inference that this shareholder did not have the requisite purpose (*Fletcher and Ors v. FC of T* 91 ATC 4950 at 4958; (1991) 22 ATR 613 at 623).

156. If a guarantor has received a fee for agreeing to guarantee a debt and pays out the creditor under the guarantee, then it is usual that the debt of the guarantor came to be owed in the course of gaining or producing the (fee) income and would not be a personal-use asset. However, if the amount of the fee is not commensurate with the risk undertaken by the guarantor, there would, again, be an inference that the gaining or producing of the fee was not the purpose of the giving of the guarantee.

When an outgoing is both deductible under subsection 51(1) and a capital loss under Part IIIA

157. A capital loss is deemed to be incurred on the disposal of a debt if the reduced cost base exceeds the disposal consideration: paragraph 160Z(1)(b). Subsections 160ZH(3) and 160ZK(1) together define the reduced cost base, broadly, as the sum of the amounts of the consideration, costs and expenditure incurred in respect of the acquisition of the asset reduced by any parts of those amounts that are allowable under subsection 51(1). Provisions other than subsection 51(1) may also apply in determining the reduced cost base.

Examples

Example 1

A director/shareholder gives a guarantee

158. Red Mercedes is a director of a real estate agency which had set up a land development company, ABC Ltd. Red held shares in the company. Red lent money to the company and arranged loans to the company from a finance company to carry out a development project. The finance company made it a condition of the loan entered into in October 1994 that Red as director provide personal guarantees in relation to both principal and interest. Before the project was completed, ABC Ltd suffered financial difficulty, ultimately defaulting on the loan payments and Red was served with a claim by the finance company for $200,000. ABC Ltd later went into receivership. Red paid the finance company $50,000 in full settlement of its claims on 1 July 1995. Red claimed a deduction for the $50,000 under subsection 51(1) or a capital loss.

159. No deduction is allowable under subsection 51(1). Even if it might be thought that the loss or outgoing should satisfy the first limb, it would fail subsection 51(1) because of the capital nature of the expense. For the purposes of the second limb of subsection 51(1), Red did not carry on any business, either as an employee of ABC Ltd or as a director of the company. The payment of $50,000 to settle claims would not be incurred in carrying on a business, or would be of

a capital nature (as being akin to loan or share capital) and, therefore, would not be deductible under subsection 51(1).

160. However, for capital gains tax purposes, the debt which came to be owed to Red Mercedes in respect of the guarantee payment, is not a personal-use asset for subparagraph 160B(1)(b)(ii) because it can be objectively determined that the primary purpose in entering into the guarantee was the expectation of promoting the future flow of dividends to Red as a shareholder. A capital loss would be allowable under paragraph 160Z(1)(b).

Example 2

Assignment of right of indemnity

161. The facts are the same as Example 1, except that Red Mercedes assigns the right of indemnity to his son, Blue, for a nominal sum of $10 on 1 March 1995. Later, Red pays (on 1 July 1995) the amount he is obliged to pay under the guarantee. Red claims a capital loss on disposal of the right of indemnity, for the amount of the payment, $50,000, in the 1994-95 year of income.

162. No capital loss is available because Red's payment is made to the creditor in order to satisfy Red's obligations under the contract of guarantee and not in respect of the acquisition of the right of indemnity. No right of subrogation can arise if the right of indemnity does not exist at the time of payment (refer to paragraph 93 above).

Example 3

Parent company guarantees debts of subsidiary

163. A debtor (SubCo Ltd), which is an operating subsidiary of ParentCo Ltd, borrows $10 million from a creditor (Mr Big) for ten years with principal repayable at maturity at an annual interest rate of ten percent. Interest and principal are guaranteed by ParentCo Ltd. SubCo Ltd makes payments of interest for five years but defaults on making further payments. ParentCo Ltd satisfies its guarantee obligation with full payment of interest and principal owing.

164. Mr Big has two assets, being the debt with a cost base equal to the amount of the debt and the contractual rights under the guarantee which Mr Big acquires for a nil value cost base: paragraphs 160ZH(4)(a) and 160ZH(4)(b). There is a disposal of the rights under the guarantee for the purposes of paragraph 160M(3)(b) and subsection 160M(1) on ParentCo Ltd satisfying its obligation under the guarantee. Consideration which Mr Big receives under subsection 160ZD(1) on the disposal is the amount ParentCo Ltd pays under the guarantee. Therefore, a capital gain accrues to Mr Big of that amount,

which is reduced by the capital loss incurred on the disposal of the debt.

165. ParentCo Ltd gives the guarantee to support the borrowing capacity of SubCo Ltd, in aid of its operations, from which it receives payments of dividends and interest. The payment of interest and principal under the guarantee may be seen as part of the business activities of ParentCo Ltd and as incidental and relevant to the derivation of its income, under the positive limbs of subsection 51(1) but it is on capital account.

166. ParentCo Ltd is entitled to a capital loss on the disposal of the debt which came to be owed as a consequence of entering into the guarantee. ParentCo Ltd acquired a right of indemnity on entering into the contract of guarantee. At that time, there is an implied contract between SubCo and ParentCo. The right of indemnity is an asset as defined in section 160A: subparagraph (a)(iii). ParentCo Ltd is taken to acquire the right of indemnity by paragraph 160M(6B)(a). When Mr Big is repaid in full, ParentCo Ltd acquires a right of subrogation. The right of indemnity merges with the right of subrogation and the cost of the merged asset is the amount ParentCo Ltd paid under the contract of guarantee: paragraph 160ZH(4)(a) and subsection 160ZH(13). The merged asset is not a debt acquired otherwise than in the course of gaining or producing income and is, therefore, not a personal-use asset. The debt is not a personal-use asset under subparagraph 160B(1)(b)(ii) because it can be objectively determined that the debt came to be owed for the primary purpose of gaining or producing income or in the carrying on of the business of the taxpayer (as holding company). A capital loss is incurred under paragraph 160Z(1)(b) for the amount of the payment.

Example 4

Right of indemnity is a debt of a private or domestic nature

167. Miss Brown enters into a loan with a finance company to purchase an Italian sports car. The finance company asks for a personal guarantee, which is provided by Miss Brown's mother. Miss Brown has difficulty in repaying the loan instalments. The finance company proceeds to recover outstanding amounts (after repossessing the car) by serving a statement of claim on Mrs Brown as guarantor. Mrs Brown claims a capital loss is incurred on disposal of the right of indemnity against her daughter, who is not able to repay the loan, for the amount paid under the guarantee.

168. The payment is in respect of the acquisition of a right of indemnity, which is a personal-use asset under subparagraph 160B(1)(b)(ii). It is a personal-use asset because it is a debt which came to be owed otherwise than in the course of earning or producing

income. It is a debt of a private or domestic nature and no capital loss is incurred, by virtue of subsection 160Z(7).

Tables

169. The following tables summarise the capital gains tax consequences for a principal debtor, a creditor and a guarantor of a payment made by the guarantor under a contract of guarantee.

Parties to Guarantee	**CGT Consequences on Disposal of Assets**						
Principal debtor	No CGT consequences - no asset owned or disposed of by principal debtor						
Creditor	**Assets**						
	Debt owed by principal debtor	*- principal debtor pays creditor's debt in full*	*- guarantor pays creditor's debt in full*	*- debtor pays part of debt and guarantor pays balance*	*- creditor recovers part only of the debt*	*- creditor forgives the debt*	*- both debtor & creditor default*
		No CG or CL (para 15)	CL of amount of debt (para 18)	CL for amount of shortfall (para 19)	CL for amount of shortfall (paras 22 and 23)	Possible CL- depends on market value of debt (para 28)	CL of amount of debt (para 26)
	Creditor's contractual rights under guarantee	No CG or CL (para 16)	CG for amount of payment, offset by CL on debt (para 17)	CG for amount of payment, offset by CL on debt (para 19)	CG for amount of payment, if any, offset by CL on debt (paras 22 and 24)	No CG or CL (para 29)	Possible CG- depends on market value of guarantee (para 26)

Parties to Guarantee						
Guarantor	**Assets**					
		Guarantor pays the guaranteed debt and:				
	Right of indemnity	*- principal debtor pays guarantor in part*	*- guarantor forgives the debt owing to him/her from the debtor*	*- guarantor assigns right of indemnity*	*- principal debtor is bankrupted or liquidated*	*- no likelihood debt will be repaid to guarantor*
	OR	Possible CL to extent of shortfall (para 43) unless personal-use asset	Possible CL- depends on market value (para 41) unless personal-use asset	Possible CG; possible CL unless personal-use asset (para 39)	Possible CL (para 42) unless personal-use asset	Possible CL (paras 40 and 41) unless personal-use asset
	Rights of indemnity and subrogation - merged asset	Possible CL to extent of shortfall (paras 35, 36 and 43) unless personal-use asset	Possible CL- depends on market value (paras 35, 36 and 41) unless personal-use asset	Right of subrogation will not arise (para 93)	Possible CL (paras 35, 36 and 42) unless personal-use asset	Possible CL (paras 36, 37 and 40) unless personal-use asset
	Personal-use asset?	No-if debt came to be owed in course of gaining or producing income/carrying on business (paras 46 and 47)	No-if debt came to be owed in course of gaining or producing income/carrying on business (paras 46 and 47)	No - if debt came to be owed in course of gaining or producing income/carrying on business (paras 46 and 47)	No - if debt came to be owed in course of gaining or producing income/carrying on business (paras 46 and 47)	No - if debt came to be owed in course of gaining or producing income/carrying on business (paras 46 and 47)

Detailed contents list

170. Below is a detailed list of the contents of this Ruling:

	Paragraph
What this Ruling is about	**1**
Class of person/arrangement	1
Definition	**5**
Ruling	**6**
Principal debtor (i.e., borrower)	8
The creditor (i.e., lender)	9
Acquisition and disposal of the assets	*9*
(i) Debt	*11*
(ii) Contractual rights under the guarantee	*12*
Cost base of the debt	*13*
Cost base of the contractual rights under the guarantee	*14*
Principal debtor pays the debt in full	*15*
Guarantor pays the guaranteed amount in full in satisfaction of the debt owing	*17*
Principal debtor pays part of debt and guarantor pays balance	*19*
Creditor recovers less than the amount of the loan	*20*
Both the debtor and the guarantor default on request for repayment	*26*
Creditor receives payment from solvent guarantor	*27*
Creditor forgives the debt	*28*
(i) Debt	*28*
(ii) Contractual rights under the guarantee	*29*
The guarantor	30
Acquisition of rights by a guarantor	*30*
The guarantor's right of indemnity	*30*
The guarantor's right of subrogation	*32*
The right of indemnity is a debt for the purposes of Part IIIA	*37*
Disposal of the debt by the guarantor	*38*

Subsection 51(1) *45*
Whether a capital loss is incurred on disposal of the debt owing to the guarantor *46*
Subsection 160B(1) - personal-use asset *46*
Date of effect **48**
Explanations **49**
General law 49
Principal debtor 52
The creditor 54
Consideration given by the creditor *58*
Alternative view *75*
Recovery against both guarantor and debtor *76*
How are the creditor's assets disposed of? *80*
If the principal debtor pays the debt *80*
If the creditor forgives the debt *81*
If the principal debtor defaults and the guarantor is called on to pay *82*
If both the principal debtor and the guarantor default *83*
The guarantor 84
Effect of guarantor making payment to the creditor *84*
Acquisition of the guarantor's assets 88
Right of indemnity *88*
Right of subrogation *89*
Whether the rights of indemnity and subrogation are assets for Part IIIA purposes *94*
Time of acquisition of rights of indemnity and subrogation at general law *96*
On payment by the guarantor, the right of indemnity becomes an enforceable debt *99*
Time of acquisition of rights of indemnity and subrogation under Part IIIA *103*
Position of the principal debtor *104*
Position of the guarantor *109*
Alternative view *115*

Disposal of the debt acquired by the guarantor under the right of indemnity (once the right of indemnity is enforceable) *118*

Assignment of the right to indemnity *120*

Subsection 51(1) *124*

If creditor seeks payment from guarantor rather than debtor *124*

Company and subsidiary *126*

Shareholder *135*

Deductibility of guarantee payments where the guarantor receives a fee *139*

Personal-use asset *140*

When an outgoing is both deductible under subsection 51(1) and a capital loss under Part IIIA *157*

Examples **158**

Example 1 158

A director/shareholder gives a guarantee *158*

Example 2 161

Assignment of right of indemnity *161*

Example 3 163

Parent company guarantees debts of subsidiary *163*

Example 4 167

Right of indemnity is a debt of a private or domestic nature *167*

Tables **169**

Detailed contents list **170**

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subject references
- asset
- assignment
- capital gains tax
- contractual rights
- debt
- guarantees
- indemnities
- merged asset
- personal-use asset
- property
- right of indemnity
- right of subrogation

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- ITAA 160A(a)(iii)
- ITAA 160B(1)
- ITAA 160B(1)(b)(ii)
- ITAA 160M(1)
-- ITAA 160M(2)(b)
- ITAA 160M(2)(e)
- ITAA 160M(2)(f)
- ITAA 160M(3)(b)
- ITAA 160MA(1)
- ITAA 160M(5)(b)
- ITAA 160M(6)
- ITAA 160M(6)(a)
- ITAA 160M(6)(b)
- ITAA 160M(6A)
- ITAA 160M(6A)(a)
- ITAA 160M(6A)(b)
- ITAA 160M(6A)(c)
- ITAA 160M(6A)(d)
- ITAA 160M(6B)
- ITAA 160M(6B)(a)
- ITAA 160M(6B)(b)
- ITAA 160M(7)
- ITAA 160U
- ITAA 160U(4)
- ITAA 160U(5)
- ITAA 160U(6)(a)(i)
- ITAA 160U(6)(a)(ii)
- ITAA 160U(6)(a)(iii)
- ITAA 160Z(1)
- ITAA 160Z(1)(a)
- ITAA 160Z(1)(b)
- ITAA 160Z(7)
- ITAA 160ZD
- ITAA 160ZD(1)
- ITAA 160ZD(1)(a)
- ITAA 160ZD(1)(b)
- ITAA 160ZD(2)
- ITAA 160ZD(2)(a)
- ITAA 160ZD(2A)
- ITAA 160ZD(2B)
- ITAA 160ZH
- ITAA 160ZH(1)(a)
- ITAA 160ZH(2)(a)
- ITAA 160ZH(3)
- ITAA 160ZH(3)(a)
- ITAA 160ZH(4)(a)
- ITAA 160ZH(4)(b)
- ITAA 160ZH(9)(a)
- ITAA 160ZH(9)(b)
- ITAA 160ZH(11)
- ITAA 160ZH(12)
- ITAA 160ZH(12)(a)
- ITAA 160ZH(12)(b)
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