


CR 2002/13 - Income tax: Investment in the Wattle Group

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Class Ruling

Income tax: Investment in the Wattle Group

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Preamble

*The number, subject heading, and the **What this Class Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the **Taxation Administration Act 1953**. CR 2001/1 explains **Class Rulings** and **Taxation Rulings** TR 92/1 and TR 97/16 together explain when a **Ruling** is a public ruling and how it is binding on the Commissioner.*

What this Class Ruling is about

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax law(s)’ identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- Section 19 of the *Income Tax Assessment Act 1936* (‘ITAA 1936’);
 - Subsection 19(1) of the ITAA 1936;
 - Subsection 25(1) of the ITAA 1936;
 - Section 26BB of the ITAA 1936;
 - Section 63 of the ITAA 1936;
 - Subsection 63(1) of the ITAA 1936;
 - Paragraph 63(1)(a) of the ITAA 1936;
 - Section 70B of the ITAA 1936;
 - Subsection 70B(4) of the ITAA 1936;
 - Section 159GP of the ITAA 1936;
 - Subsection 159GP(1) of the ITAA 1936;
 - Subsection 159GP(3) of the ITAA 1936;
 - Subparagraph 160A(a)(ii) of the ITAA 1936;

- Subsection 6-5(1) of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- Subsection 6-5(2) of the ITAA 1997;
- Subsection 6-5(4) of the ITAA 1997;
- Section 25-35 of the ITAA 1997;
- Paragraph 25-35(1)(a) of the ITAA 1997;
- Section 102-20 of the ITAA 1997;
- Section 102-22 of the ITAA 1997;
- Section 104-25 of the ITAA 1997;
- Section 108-5 of the ITAA 1997;
- Section 110-25 of the ITAA 1997;
- Paragraph 110-25(2)(a) of the ITAA 1997;
- Paragraph 110-25(2)(b) of the ITAA 1997; and
- Section 116-20 of the ITAA 1997

Class of persons

3. The class of persons to whom this Ruling applies are individual investors who account for interest income on a cash basis and who lent money to Geoffrey Robert Dexter, trading as The Wattle Group. This Ruling also applies to investors who account for interest income on an accruals basis, other than financial institutions (which are covered by Taxation Ruling TR 93/27 and Taxation Ruling TR 94/32).

Qualifications

4. The Commissioner makes this Ruling based on the precise arrangement identified in this Ruling.

5. The class of persons defined in this Ruling may rely on its contents provided the arrangement described below at paragraphs 9 to 15 is carried out in accordance with the details of the arrangement provided in this Ruling.

6. If the arrangement described in this Ruling is materially different from the arrangement that is actually carried out:

- (a) this Ruling has no binding effect on the Commissioner because the arrangement entered into is not the arrangement on which the Commissioner has ruled; and
- (b) this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies from 1 July 1992.

Arrangement

9. The Wattle Group ('Wattle') was an unincorporated investment vehicle operated by Geoffrey Robert Dexter. There was no prospectus issued in respect of Wattle.

10. Investments in Wattle were made by way of unsecured loan, documented in a loan agreement of which there were various versions.

11. In most cases, fund 'administrators' promoted the scheme to investors and took a commission, paid by Wattle, on investments they had facilitated.

12. The loan agreements provided that the loans would bear interest. Interest was generally said to be at the rate of 50% per annum, or 5% per month, calculated on a daily basis and payable no later than 30 days after the end of each calendar monthly period. However, not all loan agreements specified an interest rate and interest was not guaranteed under all variations of the loan agreement.

13. On signing the loan agreement, investors were required to make an election as to whether they requested Wattle to "re-borrow" the interest earned on the same terms as the original loan. Alternatively, investors could be paid their interest entitlement by Wattle.

14. Wattle was wholly dependant on obtaining funds from lenders through the use of the administrators as promoters, in order to pay existing lenders their interest entitlements: *Christensen and Australian Securities and Investments Commissioner* [2000] AATA 531. The Commissioner understands that only a small fraction of the money lent to Wattle was put to income-producing purposes. For the most

part, in-flowing cash was disbursed by way of repayments of principal and interest to other lenders and payments of commissions to administrators.

15. The Supreme Court of Queensland issued an injunction in March 1998 which restrained Wattle from further trading. Geoffrey Robert Dexter was declared bankrupt on 26 May 1998.

Ruling

Cash basis taxpayers

16. Actual payments of interest, such as by cash or a cheque honoured by the relevant bank, made to investors in respect of loans made to Wattle are assessable income to the investor.

17. Interest that notionally accrued to investors but was automatically “re-lent” to Wattle under the loan agreement, without ever being paid out, is not assessable income to the investor.

18. Investors can claim a capital loss if the distribution they receive from the bankrupt’s estate in respect of the principal sum invested in Wattle is less than the reduced cost base of that investment. This capital loss arises when the bankrupt is released from provable debts in accordance with the *Bankruptcy Act 1966*.

19. Investors cannot claim a capital loss in respect of interest entitlements that were “re-lent” to Wattle under the loan agreement without ever being paid out.

20. Investors cannot claim a deduction under the traditional security provisions of section 70B of the ITAA 1936 for any loss they make on their investment in Wattle.

21. Investors are not entitled to claim a deduction under the bad debt provisions of section 63 of the ITAA 1936 or section 25-35 of the ITAA 1997.

Accruals taxpayers (non-financial institution)

22. Taxpayers accounting for interest income on an accruals basis will derive income when the interest is due and payable, regardless of actual receipt. This applies irrespective of whether the taxpayer elected to “re-lend” their interest to Wattle.

23. Taxpayers accounting for interest income on an accruals basis and who have included interest in their assessable income will be entitled to a bad debt deduction under section 63 of the ITAA 1936 or section 25-35 of the ITAA 1997 if they have not subsequently received the interest as a cash payment and if they have written the

debt off as bad during the year of income in which the deduction is claimed.

24. For both cash and accruals taxpayers, where the investor has proved the principal and interest as a single debt in the bankruptcy, the dividends paid by the trustee in bankruptcy to the investor in satisfaction of that debt may be appropriated by the investor to principal or interest.

Explanations

Cash basis taxpayers

Interest actually paid

25. The character of a receipt in the hands of the investor, rather than the character of the fund of money out of which it is paid, will determine whether or not it is income: *Trustees of H K Brodie v. IR Commissioners* (1933) 17 TC 432 at 438. Therefore, the fact that capital funds of new lenders were used to pay existing lenders their entitlements will not determine the character of the payment in the hands of the receiving investor.

26. The loans from the investors to Wattle were governed by loan agreements, which, despite the fact that they provided for a rate of interest significantly exceeding a reasonable commercial rate, nonetheless evidenced an intention to create a relationship of debtor and creditor in respect of the principal sum. The function of the payments of interest to investors was to satisfy the agreed obligation to pay interest. As such, the payments have the character of interest in the hands of the recipient.

27. Generally, interest income is derived when it is actually received or the debt for interest has been in some way discharged: *St Lucia Usines & Estates Co Ltd v. St Lucia (Col. Treasurer)* (1924) AC 508, *Leigh v. IR Commissioners* (1928) 11 TC 590; TR 98/1 para 47 and footnote 27.

28. Payments of interest made by cash or a cheque honoured by the relevant bank in respect of loans made to Wattle are actually received, and therefore are 'derived'. These payments have the character of interest and so are assessable income.

Interest 're-lent' to Wattle

29. *St Lucia Usines & Estates Co Ltd v. St Lucia (Col. Treasurer)* (1924) AC 508 and *Leigh v. IR Commissioners* (1928) 11 TC 590 envisage that a debt for interest may be discharged notwithstanding that an investor has not received an amount. This 'constructive

receipt' principle is reflected in subsection 6-5(4) of the ITAA 1997, which provides that derivation will occur as soon as the amount "is applied or dealt with in any way" on behalf of the taxpayer.

30. The application of the constructive receipt principle in relation to interest income was considered by the High Court in *Permanent Trustee Co (Executors of estate of Frederick Henry Prior, deceased) v. FC of T* (1940) 6 ATD 5.

31. Rich J discussed the predecessor to subsection 6-5(4) of the ITAA 1997, section 19 of the ITAA 1936. In respect of that clause, Rich J stated that its "object is to prevent a taxpayer escaping tax though his resources have actually been increased by the accrual of the income and its transformation into some form of capital wealth or its utilisation for some purpose": 6 ATD 5 at 2.

32. Rich J further noted that:

"To see whether income has been derived one must look to realities. Usually payment of interest by cheque involves a receipt of income but payment by a valueless cheque does not.": 6 ATD 5 at 13.

33. Based on the peculiar facts of the Wattle case, the Commissioner is of the view that, in reality, Wattle investors who re-lent their interest to the Wattle scheme did not receive anything of value that could satisfy the constructive receipt principle.

34. In order to operate, subsection 6-5(4) requires that there is an "amount" capable of being applied or dealt with. The reality of the Wattle scheme was that no amount, no benefit, and nothing of value was dealt with by Wattle on behalf of investors who "re-lent" their interest.

35. As a result, interest that was "re-lent" to Wattle without ever being paid out is not assessable income to the investor because these amounts were never derived.

36. This conclusion is based on the particular facts of the Wattle case. The same conclusion will not necessarily apply to other fraudulent investment schemes, and it is unlikely to apply to cases simply involving high risk investments.

Principal sum - capital loss

37. The "principal sum" is the original amount lent to Wattle by investors out of their own money. Subsequent loans created by way of re-lending of interest do not form part of the "principal sum".

38. The debt owing to an investor in respect of the principal sum constitutes a CGT asset under subparagraph 160A(a)(ii) of the

ITAA 1936, or section 108-5 of the ITAA 1997 for debts which arose in the 1998-99 and future income years.

39. The investor's cost base for the debt is the amount of the debt: section 110-25 ITAA 1997; TR 96/23 para 59.

40. Section 102-20 of the ITAA 1997 provides that a capital gain or loss can only arise in respect of an asset if a CGT event happens. CGT event C2 (section 104-25 ITAA 1997) will occur when Geoffrey Robert Dexter is released from all provable debts in accordance with the *Bankruptcy Act 1966*.

41. The capital proceeds from CGT event C2 are the money received or entitled to be received by the investor in respect of the event: section 116-20 ITAA 1997. The money that the investor is entitled to receive in respect of the release of the bankrupt from the debt representing the CGT asset is the amount of the bankruptcy dividend paid by the trustee in respect of that debt and appropriated by the investor to the loan principal.

42. Section 104-25 of the ITAA 1997 provides that a taxpayer makes a capital loss if the capital proceeds of the debt owing to them is less than the reduced cost base of that asset. Section 102-22 of the ITAA 1997 provides that the loss is the difference between those two amounts.

Capital loss - interest

43. The debt owing to a taxpayer arising from the reinvestment of their interest constitutes a CGT asset under subparagraph 160A(a)(ii) of the ITAA 1936, or section 108-5 of the ITAA 1997 for debts which arose in respect of 1998-99 and future income years.

44. The taxpayer's relevant cost base for the asset is zero because the taxpayer neither paid nor was required to pay any money in respect of the debt (paragraph 110-25(2)(a) ITAA 1997), nor gave any property of value in respect of acquiring the debt (paragraph 110-25(2)(b) ITAA 1997). This view is consistent with and a logical consequence of the Commissioner's view that re-lent interest is not assessable income to the investor because no amount or thing of value was dealt with on behalf of the investor.

45. As the cost base is zero, it follows that the investor will not make a capital loss from the disposal of the asset.

Traditional security

46. The loan falls within the definition of 'security' in subsection 159GP(1) of the ITAA 1936, being an unsecured loan. The security

does not bear an eligible return (subsection 159GP(3) ITAA 1936) and is therefore a traditional security: section 26BB ITAA 1936.

47. Section 70B of the ITAA 1936 allows a deduction in certain circumstances for losses on disposal or redemption of traditional securities. In the case of the unsecured loans made to Wattle, redemption will occur when Geoffrey Robert Dexter is released from provable debts in accordance with the *Bankruptcy Act 1966*.

48. However, subsection 70B(4) of the ITAA 1936 denies a deduction for a loss of capital or of a capital nature, where a reason for the disposal or redemption was a belief or apprehension that the issuer (Geoffrey Robert Dexter) would be unable or unwilling to meet its payment obligations under the security.

49. Because bankruptcy is the legal process that controls the affairs of people who are insolvent, that is, unable to pay their debts as they fall due, it is reasonable to conclude that one of the reasons for the redemption of the security was a belief that the issuer was unable to discharge all of his liabilities to pay amounts under the security.

50. Therefore no deduction will be allowable to the investor in respect of so much of the amount of the loss as is a loss of capital or a loss of a capital nature. As the funds invested in the loan represent a capital expense, the full amount of the loss will be a loss of a capital nature and not deductible under section 70B of the ITAA 1936.

51. Interest that was “re-lent” to Wattle does not constitute a ‘security’ within the definition in section 159GP of the ITAA 1936 because there was no amount of value capable of being the subject of a secured or unsecured loan within paragraph (c) of the definition.

Bad debt

52. Subsection 63(1) of the ITAA 1936, or subparagraph 25-35(1)(a) of the ITAA 1997 in respect of 1997-98 and future years, allows a taxpayer to deduct a debt that they have written off as a bad debt in the income year, provided the debt was included in their assessable income for that year or an earlier year.

53. Investors who account for their investment income on a cash basis, do not have an amount included in their assessable income in respect of the interest still owing to them by Wattle. Consequently, they cannot claim a deduction for the amount still owing because they do not meet the requirement of paragraph 63(1)(a) of the ITAA 1936 or paragraph 25-35(1)(a) of the ITAA 1997 that the amount owing has been included as assessable income.

Accruals basis taxpayers (non-financial institution)***Interest***

54. Most taxpayers, including those who account for their professional or trading income on an accruals basis, will account for the interest on the Wattle loans on a cash basis.

55. Taxpayers other than financial institutions, that account for interest income on an accruals basis will most likely be in a business of money-lending, or making the loans in the ordinary course of carrying on a business. Taxation Ruling TR 98/1 has some examples of situations where taxpayers might account for interest income on an accruals basis in paragraph 47.

56. For taxpayers who account for interest income on an accruals basis, the debt will accrue when it becomes due and payable: *Carden's Case* (1938) 63 CLR 108.

Bad debt

57. Accruals taxpayers who have included the accrued interest in their assessable income for the income year or an ordinary income year may be entitled to a bad debt deduction.

58. The debt will not be bad if it has been satisfied. Therefore, if the investor has subsequently received a cash payment in respect of the interest, no bad debt deduction will be available.

59. However, investors who have “re-lent” the interest, and who have not received cash in respect of the interest, are entitled to a bad debt deduction because the debt has not been satisfied. As discussed above, the investor has not received any real consideration to satisfy the obligation. The debt is not satisfied for the same reason that the capitalised interest is not assessable income to cash-basis taxpayers.

60. In accordance with commercial judgment and paragraph 33 of Taxation Ruling TR 92/18, a bad debt deduction should be allowed to these accruals taxpayers to the extent that the amount of the debt owed exceeds the amount, if any, which will be received by the taxpayer as a result of Geoffrey Robert Dexter being released from provable debts in accordance with the *Bankruptcy Act 1966*. This amount can be written off as bad when the trustee in bankruptcy advises the creditor of the amount expected to be paid in respect of the debt (TR 92/18, paragraph 33).

Detailed contents list

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Related Rulings/Determinations:

TR 92/1; TR 92/18; TR 93/27;
 TR 94/32; TR 96/23; TR 97/16;
 TR 98/1; CR 2001/1

Subject references:

- interest income
 - capital losses

Legislative references:

- TAA 1953 Part IVAAA

- ITAA 1936 19
- ITAA 1936 19(1)
- ITAA 1936 25(1)
- ITAA 1936 26BB
- ITAA 1936 63
- ITAA 1936 63(1)
- ITAA 1936 63(1)(a)
- ITAA 1936 70B
- ITAA 1936 70B(4)
- ITAA 1936 159GP
- ITAA 1936 159GP(1)
- ITAA 1936 159GP(3)
- ITAA 1936 160A(a)(ii)
- Bankruptcy Act 1966
- ITAA 1997 6-5(1)
- ITAA 1997 6-5(2)
- ITAA 1997 6-5(4)
- ITAA 1997 25-35
- ITAA 1997 25-35(1)(a)
- ITAA 1997 102-20
- ITAA 1997 102-22
- ITAA 1997 104-25
- ITAA 1997 108-5

- ITAA 1997 110-25
- ITAA 1997 110-25(2)(a)
- ITAA 1997 110-25(2)(b)
- ITAA 1997 116-20

Case references:

- Christensen and Australian Securities and Investments Commissioner [2000] AATA 531
- Carden's Case (1938) 63 CLR 108
- Leigh v. IR Commissioners (1928) 11 TC 590
- Permanent Trustee Co (Executors of estate of Frederick Henry Prior, deceased) v. FC of T (1940) 6 ATD 5
- St Lucia Usines & Estates Co Ltd v. St Lucia (Col. Treasurer) (1924) AC 508
- Trustees of H K Brodie v. IR Commissioners (1933) 17 TC 432

ATO References

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