


CR 2014/55 - Income tax: Australian Government Bond holders electing to exchange Bonds for CHESS Depositary Interests (CDIs)

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Class Ruling

Income tax: Australian Government Bond holders electing to exchange Bonds for CHESS Depositary Interests (CDIs)

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This publication provides you with the following level of protection:

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

What this Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* unless otherwise indicated.

Relevant provision(s)

2. The relevant provisions dealt with in this Ruling are:

- section 26BB of the *Income Tax Assessment Act 1936* (ITAA 1936)
- section 70B of the ITAA 1936
- Division 16E of Part III of the ITAA 1936
- section 6-5
- section 8-1
- section 106-50
- section 108-5
- Division 104, and
- Division 230.

Class of entities

3. The class of entities to which this Ruling applies are inscribed stock holders of Treasury Bonds (TBs) and Treasury Indexed Bonds (TIBs) (collectively referred to in this Ruling as Bonds) whose names are entered in the Commonwealth Government Inscribed Stock Registry (Registry) and who:

- (a) elect to exchange their existing holding of a Bond for a CHESS Depositary Interest (CDI) in that Bond recorded against a CHESS Holder Identification Number in their name, and
- (b) do not hold their Bonds as trading stock for income tax purposes.

Qualifications

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

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 8 to 26 of this Ruling.

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

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled, and
- this Ruling may be withdrawn or modified.

Date of effect

7. This Ruling applies from the income years ending 30 June 2014 to 30 June 2018. However, this Ruling will 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 this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Scheme

8. The following description of the scheme is based on information provided by the applicant. The following documents, or relevant parts of them, form part of and are to be read with the description:

- Class Ruling application (including attachments); and

- correspondence regarding the application between the Commissioner and the applicant.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

Background

9. Section 4 of the *Commonwealth Inscribed Stock Act 1911* provides for the creation of stock, including TBs and TIBs to enable the Government of the Commonwealth of Australia to borrow money.

10. The Australian Office of Financial Management (AOFM) is responsible for the management and administration of Bonds.

11. TBs carry a fixed annual rate of interest payable semi-annually and are redeemable on maturity at their face value of \$100. They may be issued for their face value, but are generally issued either at a premium or at a discount to their face value.

12. TIBs are issued with a face value of \$100 and their capital value is adjusted for movements in the Consumer Price Index. They are redeemable on maturity at their adjusted capital value. They carry a fixed annual rate of interest payable quarterly on the adjusted capital value. They may be issued for their face value, but are generally issued either at a premium or at a discount to their capital value.

13. Most of the Bonds on issue are traded in the secondary market by telephone or on electronic markets. These trades are settled via the 'Austraclear System' operated by Austraclear Limited (Austraclear), a wholly-owned subsidiary of ASX Limited. It is an electronic registry and settlement system for government, semi-government and private sector debt securities. Austraclear holds legal title in the inscribed stock registry maintained under the *Commonwealth Inscribed Stock Act 1911* to all of the Bonds held in the Austraclear System. Austraclear holds the Bonds in trust for the beneficial owners.

14. The remaining Bonds, not held in the Austraclear System, are held directly in the inscribed stock registry. There are approximately 600 (mainly retail) investors that hold Bonds directly in the inscribed stock registry (Bondholders) and they account for less than 0.1% of the aggregate face value of all Bonds on issue. Currently, these Bondholders may only transfer the ownership of Bonds by lodgement of a completed 'Transfer and Acceptance Form' at the Registry.

15. On 17 November 2012, the *Commonwealth Government Securities Legislation Amendment (Retail Trading) Act 2012* received Royal Assent. The Act amended the *Commonwealth Inscribed Stock Act 1911* and the *Corporations Act 2001* to facilitate trading of beneficial interests in Bonds on financial markets in Australia that are accessible to retail investors.

16. In April 2013, the Australian Securities Exchange (ASX) and the AOFM entered into an agreement which provided for the trading of CHESS Depositary Interests (CDIs) in Bonds. CDIs are beneficial interests in Bonds. On 21 May 2013, the trading of CDIs in Bonds commenced on the ASX.

17. CDIs are traded on the ASX and settle through the Clearing House Electronic Subregister System (CHESS), the settlement system for financial products traded on the ASX.

The proposed Exchange facility and CDIs

18. The AOFM is proposing to establish a voluntary exchange or 'transmutation' facility under which Bondholders may choose (during a specified period each year) to exchange an existing direct holding of a Bond for a CDI in that Bond (Exchange). This is intended:

- to allow Bondholders a simpler method than is currently available by which they can hold, manage and sell their holdings, and
- to facilitate AOFM moving all Bonds to a single register.

19. The CDIs will be issued on a 1:1 exchange basis (i.e. one CDI of \$100 will be issued for every \$100 of face value of Bonds held by a Bondholder).

20. The CDIs will be governed by the ASX Settlement Operating Rules. Pursuant to section 13 of those Rules, legal title to the Bonds currently held by Bondholders who choose to Exchange them will be transferred to the Depositary Nominee, CHESS Depositary Nominees Pty Ltd (CDN).

21. CDN will then lodge the Bond into the Austraclear System by transferring legal title to the Bond to Austraclear.

22. A CDI will be created over the Bond and the Bondholder will be recorded as the holder of the CDI in CHESS in an account established by the Bondholder.

23. The CDIs will be listed and traded on the ASX and, when traded, the CDIs will settle electronically through CHESS.

24. The Bonds will not be cancelled or redeemed.

25. The holder of a CDI will retain the beneficial ownership of the underlying Bond and be entitled to all of the economic benefits (including coupon payments and principal repayments which will be made directly to the CDI holder) and be exposed to all of the risks attached to legal ownership of the Bond. The Australian Government through the AOFM will continue to have the primary obligation for meeting the interest and principal payments due to holders of CDIs in Bonds.

26. Bondholders will not be required to pay any fees, commissions or other amounts in respect of an Exchange.

Ruling

CGT events

27. CGT event A1 (in section 104-10) and CGT event E1 (in section 104-55) will not happen when a Bondholder chooses to Exchange a Bond for a CDI.
28. CGT event H2 (in section 104-155) will happen when a Bondholder chooses to Exchange a Bond for a CDI. However, a Bondholder will not make a capital gain or a capital loss from CGT event H2 happening as there will be no capital proceeds, or incidental costs incurred, because of the Exchange.

Traditional securities – application of sections 26BB and 70B of the ITAA 1936

29. The TBs issued at face value or at a premium are traditional securities, as defined in subsection 26BB(1) and subsection 70B(1) of the ITAA 1936.
30. TIBs are not traditional securities within the meaning of subsection 26BB(1) and subsection 70B(1) of the ITAA 1936.
31. The Exchange of TBs that are traditional securities will not constitute a disposal or redemption under section 26BB or section 70B of the ITAA 1936.

Qualifying securities – application of Division 16E of Part III of the ITAA 1936

32. Where the Bonds are qualifying securities as defined in subsection 159GP(1) of the ITAA 1936, there will be no transfer of those Bonds as a result of the Exchange. Therefore, the Exchange will not give rise to assessable income or an allowable deduction under section 159GS of the ITAA 1936.

Taxation of financial arrangements – application of Division 230

33. Where Division 230 applies to a Bond, the Exchange will not give rise to a balancing adjustment under section 230-435.

Application of sections 6-5 and 8-1

34. The Exchange will not give rise to assessable income under section 6-5 or an allowable deduction under section 8-1.

Appendix 1 – Explanation

■ *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

CGT events

35. A Bond is a CGT asset: section 108-5.

36. CGT event A1 happens if a taxpayer disposes of a CGT asset (subsection 104-10(1)), and the disposal involves a change of ownership from the taxpayer to another entity. However, a change of ownership does not occur if the taxpayer stops being the legal owner of the asset but continues to be its beneficial owner (subsection 104-10(2)).

37. CGT event E1 happens when a taxpayer creates a trust over a CGT asset by declaration or settlement (subsection 104-55(1)). However, subsection 104-55(5) provides that CGT event E1 does not happen if the taxpayer is the sole beneficiary of the trust and:

- is absolutely entitled to the asset as against the trustee (disregarding any legal disability); and
- the trust is not a unit trust.

38. CGT event H2 happens when an act, transaction or event occurs in relation to a CGT asset that a taxpayer owns and that act, transaction or event does not result in an adjustment being made to the asset's cost base or reduced cost base (section 104-155).

39. Under section 106-50, a CGT asset of a trust to which a beneficiary is absolutely entitled as against the trustee (disregarding any legal disability) is treated for CGT purposes as being the beneficiary's asset (rather than an asset of the trust). Furthermore, any act done in relation to the asset by the trustee is taken to be done by the absolutely entitled beneficiary (rather than the trustee).

40. The ASX has instituted a system of trading the Bonds which involves a CDI as the instrument of ownership of a Bond. The CDI is the means by which (following the Exchange) Bondholders will continue to enjoy the advantages of ownership of Bonds, including the ability to sell them.

41. In accordance with ASX requirements, a trust is created over a Bond to facilitate its transmutation to a CDI. Only the CDI holder has a right to benefit from the Bond or to deal with it (the CDI being the medium through which they do so).

42. Accordingly, the CDI holder will be absolutely entitled to the Bond for the purposes of the CGT provisions.

43. Therefore, the Exchange will not trigger a disposal to another entity as that term is defined in subsection 104-10(2) (meaning CGT event A1 will not happen), and the exception in subsection 104-55(5) will apply (meaning CGT event E1 will not happen).

44. The Exchange will cause CGT event H2 to happen, being an act, transaction or event which occurs in relation to a Bond and does not result in an adjustment being made to the Bond's cost base or reduced cost base.

45. As a Bondholder will receive no capital proceeds (defined in subsection 116-20(2) for the purposes of CGT event H2) from the Exchange and will incur no incidental costs that relate to the Exchange, a Bondholder will not make a capital gain or a capital loss from CGT event H2 happening as a result of the Exchange.

Traditional securities – application of sections 26BB and 70B of the ITAA 1936

46. A 'traditional security' is defined in subsection 26BB(1) of the ITAA 1936 as a 'security' that:

- is or was acquired by the taxpayer after 10 May 1989
- does not have an eligible return or has an eligible return that meets certain conditions
- is not a prescribed security within the meaning of section 26C of the ITAA 1936, and
- is not trading stock.

47. A Bond which is a TB issued at face value or at a premium is a traditional security, as it satisfies paragraph (a) of the definition of 'security' in subsection 159GP(1) of the ITAA 1936, and does not have an 'eligible return' as defined in subsections 159GP(1) and (3) of the ITAA 1936.

48. A gain on the disposal or redemption of a traditional security will give rise to assessable income under subsection 26BB(2) of the ITAA 1936. A loss on the disposal or redemption of a traditional security will give rise to an allowable deduction under subsection 70B(2) of the ITAA 1936.

49. The Exchange is merely the mechanism through which a CDI is issued to a Bondholder in respect of the underlying Bond to facilitate its subsequent realisation or disposal on the ASX.

50. The Exchange will plainly not constitute the redemption of the Bond and, as it does not result in the sale, transfer or assignment of the Bond, nor will it constitute a disposal of the Bond for the purposes of sections 26BB and 70B of the ITAA 1936.

Qualifying securities – application of Division 16E of Part III of the ITAA 1936

51. Bonds which are TIBs, or TBs issued at a discount, are likely to have an eligible return (as defined in subsections 159GP(1) and (3) of the ITAA 1936) and therefore are likely to constitute a 'qualifying security' within the meaning of subsection 159GP(1) of the ITAA 1936.

52. Where the Bonds are qualifying securities, the 'transfer' (as defined in subsection 159GP(1) of the ITAA 1936) of a qualifying security will give rise to assessable income under subparagraph 159GS(1)(a)(i), paragraph 159GS(1)(b) and paragraph 159GS(2)(b) of the ITAA 1936. The transfer of a qualifying security will give rise to an allowable deduction under subparagraph 159GS(1)(a)(ii) and paragraph 159GS(2)(a) of the ITAA 1936.

53. However, the Exchange will not result in a 'transfer' of the Bond for the same reasons that it will not constitute the disposal or redemption of a traditional security for the purposes of sections 26BB and 70B of the ITAA 1936. Therefore, the Exchange will not give rise to assessable income or an allowable deduction under section 159GS of the ITAA 1936.

Taxation of financial arrangements – application of Division 230

54. A Bond is a 'financial arrangement' within the meaning of section 230-45.

55. To the extent that Division 230 is capable of applying to a Bond, the Exchange will give rise to a balancing adjustment under subsection 230-435(1) if:

- (a) the Bondholder transfers to another entity all of their rights and/or obligations under the Bond
- (b) all of the Bondholder's rights and/or obligations under the Bond otherwise cease
- (c) the Bondholder transfers to another entity a proportionate share of their rights and/or obligations under the Bond, or
- (d) the Bond ceases to be a Division 230 financial arrangement.

56. The Exchange of a Bond will not give rise to a balancing adjustment under subsection 230-435(1) for the following reasons:

- The Bonds are assets of the Bondholders, who will not transfer 'substantially all the risks and rewards of ownership of the interest' in the Bonds as a result of the Exchange (subsection 230-435(3)), so that paragraphs (a) and (c) above are not satisfied.

- The Bondholder will retain the right to coupon payments and principal repayment in respect of the Bond, so that paragraph (b) above is not satisfied;
- The Bond does not cease to be a Division 230 financial arrangement as a result of the Exchange, so that paragraph (d) above is not satisfied.

Application of sections 6-5 and 8-1

57. To the extent that a Bond is a 'revenue asset', the Exchange will not constitute the realisation of a Bond by the Bondholder. Therefore, the Exchange will not give rise to any profit which is included in assessable income under section 6-5 or a loss which is an allowable deduction under section 8-1.

Appendix 2 – Detailed contents list

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References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 96/14; TR 2006/10;
TR 2004/D25

Subject references:

- commonwealth bonds
- government bonds

Legislative references:

- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 26C
- ITAA 1936 70B
- ITAA 1936 70B(1)
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159GP(1)
- ITAA 1936 159GS
- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Part 3-1
- ITAA 1997 Div104

- ITAA 1997 104-10
- ITAA 1997 104-10(1)
- ITAA 1997 104-10(2)
- ITAA 1997 104-55
- ITAA 1997 104-55(1)
- ITAA 1997 104-55(5)
- ITAA 1997 104-155
- ITAA 1997 104-155(1)
- ITAA 1997 104-155(3)
- ITAA 1997 108-5
- ITAA 1997 Part 3-3
- ITAA 1997 Div 230
- ITAA 1997 230-45
- ITAA 1997 230-435
- ITAA 1997 230-435(1)
- ITAA 1997 230-435(3)
- TAA 1953
- Copyright Act 1968
- Commonwealth Inscribed Stock Act 1911 4
- Commonwealth Government Securities Legislation Amendment (Retail Trading) Act 2012

ATO references

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