


# ***CR 2018/4 - Income tax: Australian Government Bond holders electing to exchange bonds for CHESS Depository Interests (CDIs)***

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## Class Ruling

### Income tax: Australian Government Bond holders electing to exchange bonds for CHESS Depository Interests (CDIs)

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#### **❶ 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.

## Summary – 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.

#### 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 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- section 8-1 of the ITAA 1997
- section 106-50 of the ITAA 1997
- section 108-5 of the ITAA 1997
- Division 104 of the ITAA 1997

- Division 230 of the ITAA 1997.

All subsequent legislative references in this Ruling are to the ITAA 1997 unless otherwise indicated.

## **Class of entities**

3. The class of entities to which this Ruling applies are holders of Treasury Bonds (TBs) and Treasury Indexed Bonds (TIBs) (collectively referred to in this Ruling as bonds) whose names are directly entered in the inscribed stock ledger governed by the *Commonwealth Inscribed Stock Act 1911*, and holders of bonds which are deposited electronically in the Austraclear System and held by Austraclear Limited as nominee for the beneficial holder, who:

- elect to exchange their existing holding of a bond for a CHESS Depository Interest (CDI) in that bond recorded against a CHESS Holder Identification Number in their name, and
- 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 9 to 27 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**

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7. This Ruling applies from the income years ended 30 June 2019 to 30 June 2022. The Ruling continues to apply after 30 June 2022 to all entities within the specified class who entered into the specified scheme during the term of the Ruling. 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

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8. The following description of the scheme is based on information provided by the applicant.

### Background

9. Section 4 of the *Commonwealth Inscribed Stock Act 1911* (CIS Act) provides for the creation of stock, including TBs and TIBs, to enable the Australian Government 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 at their face value on maturity. 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.

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. The Austraclear System is an electronic registry and settlement system for government, semi-government and private sector debt securities. Austraclear holds legal title in the inscribed stock ledger maintained under the CIS Act to all of the bonds held in the Austraclear System. Austraclear holds the bonds as nominee for the beneficial owners (beneficial bondholders).

14. The remaining bonds issued under the CIS Act that are not held in the Austraclear System are held in the inscribed stock ledger. There are approximately 250 (mainly retail) investors that hold bonds directly in the inscribed stock ledger (direct bondholders) and they account for less than 0.1% of the aggregate face value of all bonds on issue.

15. In 2013, the Australian Securities Exchange (ASX) and the AOFM established a facility to allow retail investors to trade in exchange-traded Australian Government Bonds. These are known as exchange-traded Treasury Bonds (eTBs) and exchange-traded Treasury Indexed Bonds (eTIBs). These bonds are not issued under the CIS Act. Instead, retail investors acquire beneficial interests in TBs or TIBs. Accordingly, the *Corporations Act 2001* was amended to facilitate trading of beneficial interests in TBs and TIBs on financial markets in Australia that are accessible to retail investors.

16. These beneficial interests are collectively known as CHESS Depository Interests (CDIs) in bonds. Trading of CDIs in bonds commenced on the ASX on 21 May 2013.

17. CDIs settle through the Clearing House Electronic Sub-register System (CHESS), the settlement system for financial products traded on the ASX, and are recorded on the Australian Government Bond Depository Interest Register.

## **The proposed inscribed exchange facility and CDIs**

18. The AOFM is proposing to establish a voluntary exchange or 'transmutation' facility under which bondholders may choose to exchange an existing direct or beneficial holding of a bond for a CDI in that bond. This is intended to:

- allow direct bondholders a simpler method than is currently available by which they can hold, manage and sell their holdings
- enable beneficial bondholders to transfer an existing holding from the Austraclear System participant account to a CDI, and
- facilitate the AOFM to consolidate its registers.

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

20. In the case of beneficial bondholders, the bond will first be withdrawn from the Austraclear System to the beneficial bondholder, with legal title transferred in the inscribed stock ledger.

21. 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 direct or beneficial bondholders who choose to exchange them will then be transferred to the depository nominee, CHESS Depository Nominees Pty Ltd (CDN).

22. CDN will then lodge the bond into the Austraclear System by transferring legal title to the bond to Austraclear.

23. A CDI will be created over the bond and the bondholder will be recorded as the holder of the CDI in a broker sponsored CHESS account established by the bondholder.

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

25. The bonds will not be cancelled or redeemed.

26. 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.

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

## **Ruling**

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### **CGT events**

28. 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.

29. 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, arising from the transmutation process.

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

30. 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.

31. TIBs are not traditional securities within the meaning of subsection 26BB(1) and subsection 70B(1) of the ITAA 1936.

32. 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**

33. 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 159GP of the ITAA 1936.

## **Taxation of financial arrangements – application of Division 230**

34. 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**

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

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**Commissioner of Taxation**

24 January 2018

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## Appendix 1 – Explanation

**❶** *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

36. A bond is a CGT asset: section 108-5.

37. 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)).

38. 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.

39. A trust is an entity for income tax purposes (subsection 960-100(1)).

40. The trustee of a trust is taken to be an entity consisting of the person who is the trustee, or persons who are trustees, at any given time (subsection 960-100(2)). The mere appointment of a new trustee to a trust will not cause a disposal for income tax purposes.

41. 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 104-55).

42. 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).

43. 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 direct and beneficial bondholders will continue to enjoy the advantage of ownership of bonds, including the ability to sell them, following the exchange.

44. In accordance with ASX requirements, where a direct bondholder holds a bond on the inscribed stock ledger, a trust is created over a bond to facilitate its transmutation to a CDI.



45. Where a beneficial bondholder holds a bond on the Austraclear System, a trust already exists over the bond. The transmutation to a CDI results in the mere change of trustee.

46. Only the CDI holder has the right to benefit from the bond or to deal with it (the CDI being the medium through which they do so).

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

48. 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).

49. 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.

50. 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 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**

51. 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.

52. 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.

53. 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.

54. 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.

55. The exchange will 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**

56. 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.

57. 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.

58. 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 section 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**

59. A bond is a 'financial arrangement' within the meaning of section 230-45.

60. 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 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.

61. 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, and
- 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**

62. 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**

64. The following is a detailed contents list for this Ruling:

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## References

### *Previous draft:*

Not previously issued as a draft

### *Related Rulings/Determinations:*

TR 2006/10; CR 2014/55

### *Legislative references:*

- ITAA 1997 6-5
- ITAA 1997 8-1
- ITAA 1997 Div 104
- 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 106-50
- ITAA 1997 108-5
- ITAA 1997 116-20(2)
- ITAA 1997 Div 230
- ITAA 1997 230-45
- ITAA 1997 230-435
- ITAA 1997 230-435(1)
- ITAA 1997 230-435(3)
- ITAA 1997 960-100(1)
- ITAA 1997 960-100(2)
- Commonwealth Inscribed Stock Act 1911
- Commonwealth Inscribed Stock Act 1911 4
- Corporations Act 2001
- TAA 1953
- ITAA 1936
- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 26BB(2)
- ITAA 1936 26C
- ITAA 1936 70B
- ITAA 1936 70B(1)
- ITAA 1936 70B(2)
- ITAA 1936 Pt III Div 16E
- ITAA 1936 159G
- ITAA 1936 159GP(1)
- ITAA 1936 159GP(3)
- ITAA 1936 159GS
- ITAA 1936 159GS(1)(a)(i)
- ITAA 1936 159GS(1)(a)(ii)
- ITAA 1936 159GS(1)(b)
- ITAA 1936 159GS(2)(a)
- ITAA 1936 159GS(2)(b)
- ITAA 1997

### ATO references

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Income tax ~~ Assessable income ~~ Other types of income ~~ Traditional securities

Income tax ~~ Assessable income ~~ Other types of income ~~ Other

Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT event A1 – disposal of a CGT asset

Income tax ~~ Capital gains tax ~~ CGT events ~~ CGT event E1 to E9 – trusts

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Income tax ~~ Taxation of financial arrangements (TOFA) ~~ Application of TOFA - other

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