TR 92/D39 - Income tax: basis of assessment of interest paid in advance and received in advance by financial institutions

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Australian Taxation Office

Draft Taxation Ruling
Income tax: basis of assessment of interest paid in advance and received in advance by financial institutions

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CITCM 844

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What this Ruling is about

1. This Ruling clarifies when interest received and paid in advance by a financial institution is to be brought to account as income or is allowable as a deduction for the purposes of the *Income Tax Assessment Act 1936* ('the Act'). The Ruling proceeds on the general basis that interest received is assessable under subsection 25(1), and interest paid is deductible under subsection 51(1), to taxpayers that are financial institutions.

2. The types of financial instruments and investments to which this Ruling applies includes:

- overdrafts, term loans, personal and other loans;
- interest bearing deposits; and
- securities issued or held by financial institutions.

3. This Ruling does not apply to interest rate swaps of the kind discussed in Taxation Rulings IT 2050 and 2682 nor does it have any application to 'qualifying securities' as defined in subsection 159GP(1) in Division 16E of Part III of the Act. Further, this Ruling does not apply to bills of exchange, promissory notes and other commercial paper issued at a discount to which Division 16E does not apply (for example, by reason of their term being less than twelve months).

Ruling

4. A distinction may be drawn between certain taxpayers that operate in the financial markets. On the one hand there are those that carry on business as lenders, financiers and investors by taking deposits and borrowing funds and then on-lending or investing those funds for income earning purposes. On the other hand there are those taxpayers that invest substantial amounts of money as part of their investment function but do not finance their operations to any significant extent with borrowed funds. Rather, their activities are financed by way of equity or deriving premiums that by their nature do not involve any interest expense. That is, in the latter circumstances borrowings play no, or only a limited, part in the business activities of the enterprise.

5. Whilst both kinds of taxpayers might generally be described as financial institutions this Ruling only applies to taxpayers that principally, and in the ordinary course of their business operations, derive assessable income by lending or investing funds obtained by way of deposit or borrowing. These features make the accounting principle of matching expense to revenue an appropriate basis for such businesses to tax account for interest derived and incurred. Generally speaking, taxpayers that are not moneylenders would be excluded from the application of this Ruling.

6. Examples of taxpayers that fall within the restricted meaning of 'financial institution' used in this Ruling include banks, merchant banks, finance companies (including 'in-house' finance companies), building societies, credit unions and moneylenders. Examples of taxpayers that do not fall within the restricted meaning of 'financial institution' used in this Ruling include insurance companies (both general and life), approved deposit funds, cash management trusts, friendly societies and superannuation funds.

7. A full explanation of the restricted meaning of 'financial institution' used in this Ruling is contained at paragraphs 12 to 21 of Exposure Draft Ruling TR 92/D38.

8. In broad terms, the combined effect of sections 82KZL and 82KZM of the Act is to accrue deductions for amounts of interest paid in advance for periods greater than 13 months over the lesser of the period to which the interest payment relates or ten years. However, where prepaid interest is either paid under an agreement entered into on or before 25 May 1988, is less than $1,000, or relates to a period of 13 months or less, the advance expenditure provisions do not apply and the usual tests for deductibility under section 51 need to be considered. Generally speaking, in these circumstances and where the payment is unconditional in the sense that the lender is under no

obligation to refund the interest payment, it is considered that the liability for the entire payment is incurred at the time of payment.

9. In circumstances where a borrower pays interest in advance for funds lent by a financial institution and the loan agreement under which the funds are lent does not provide the borrower with any right to repayment of prepaid interest, the financial institution will derive the interest income at the time of receipt. On the other hand, where the relevant loan agreement provides for the contingency of a refund of prepaid interest to the borrower in light of early repayment of the loan the financial institution should accrue the prepaid interest over the period to which the interest relates.

Date of effect

10. This Ruling applies (subject to any limitations imposed by statute) for years of income commencing both before and after the date on which it is issued. To the extent that this Ruling is concerned with changes in interpretation, those changes operate in favour of taxpayers. Consequently, if a taxpayer has a private ruling which is inconsistent with this Ruling, then this Ruling will only apply to that taxpayer from and including the 1992-93 year of income unless the taxpayer asks that it apply (subject to any limitations imposed by statute) to earlier income years.

Explanations

Definition of a financial institution

11. A distinction may be drawn between certain taxpayers that operate in the financial markets. On the one hand there are those that carry on business as lenders, financiers and investors by taking deposits and borrowing funds and then on-lending or investing those funds for income earning purposes. On the other hand there are those taxpayers that invest substantial amounts of money as part of their investment function but do not finance their operations to any significant extent with borrowed funds. Rather, their activities are financed by way of equity or deriving premiums that by their nature do not involve any interest expense. That is, in the latter circumstances borrowings play no, or only a limited, part in the business activities of the enterprise.

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Interest paid in advance

15. Subdivision H of Division 3 of Part III of the Act modifies the operation of section 51 in relation to the timing of deductions for certain expenditure of $1,000 or more incurred in advance of services to be provided over periods greater than 13 months. The advance expenditure provisions apply to agreements entered into after 25 May 1988. The combined effect of sections 82KZL and 82KZM is to accrue deductions for prepaid interest over the lesser of the period to which the interest payment relates or ten years.

16. The Explanatory Memorandum which accompanied the introduction of *Taxation Laws Amendment Bill (No. 4) 1988* ('the EM') indicates that section 82KZM applies to prepayments for services to be provided over periods greater than 13 months. This reflects the policy set out by the Treasurer in his May 1988 Economic Statement. The intention of the legislation is to create symmetry between advance expenditure and either the service to be provided or the income to flow. The types of services intended to be covered by the prepayment provisions include the provision of finance and thus prepayments of interest.

17. Subsection 82KZL(2) is an interpretative provision which clarifies the operation of Subdivision H in relation to expenditure in the nature of interest. Paragraph 82KZL(2)(a) provides that the payment of 'loan interest' or a payment similar in nature to interest is payment for 'the doing of a thing' (the provision of the loan principal) for the purposes of Subdivision H. Section 82KZM then requires any

section 51 deduction for such prepaid interest to be spread over the 'eligible service period', up to a maximum of 10 years.

18. The EM states that in determining the 'eligible service period' over which deductions for interest paid are required to be spread, reference should be made to the period to which the interest relates 'and not the period of the loan'.

19. The EM also warns that the general anti-avoidance provisions of Part IVA would be applied in appropriate cases in respect of arrangements that seek to exploit the $1,000 threshold for the purposes of avoiding the application of Subdivision H.

20. Where prepaid interest is either paid under an agreement entered into on or before 25 May 1988, or is less than $1,000, or relates to a period of 13 months or less, the advance expenditure provisions do not apply and the usual tests for deductibility under section 51 need to be considered. Generally speaking, in these circumstances and where the payment is unconditional in the sense that the lender is under no obligation to refund the interest payment, it is considered that the liability for the entire payment is incurred and deductible at the time of payment.

Interest received in advance

21. The courts regard interest to be a reward earned for the service of lending, the interest being earned as money is left outstanding (cf. *Commissioner of Inland Revenue v. The National Bank of New Zealand* 77 ATC 6001 at 6023, 6026 & 6032; (1977) 7 ATR 282 at 295, 298 & 306; *Willingale (H.M. Inspector of Taxes) v. International Commercial Bank Limited* (1978) 52 TC 242 at 271. In *Commissioner of Inland Revenue v. The National Bank of New Zealand* Cooke J related interest to the reward for the provision of a service when he stated (supra at ATC 6023; ATR 295):

> 'In relation to interest on a loan the service is performed when the principal is left outstanding.' (Underline added).

22. The Courts have not laid down any rule of universal application in relation to payments made and received in advance for either the provision of future goods or services, or the exercise of forbearance *in futuro*. The Full High Court decision in *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314 (*Arthur Murray*) is often argued as being authority for the principle that, consistent with established accounting principles and practice, income received in advance for services to be rendered in the future should be accrued over the term of the services to which the income relates. In *Arthur Murray* the Court decided that fees paid in advance for dancing lessons were not

income derived until such time as the actual lessons had been rendered and the fees thereby earned.

23. However, the decision in *Arthur Murray* must be read subject to the facts that were before the Court. The appeal to the High Court was by way of a case stated (supra at CLR 316-7) and the Court's decision turned substantially on a factual situation about which the parties were in agreement. This was emphasised by Kitto J in *Country Magazine Pty Limited v. FC of T* (1968) 117 CLR 162 at 164. In *Arthur Murray* some reliance was placed on the fact that the taxpayer, whilst not legally bound to do so, would have refunded the fees to the students if the dance lessons were not performed.

24. It was an agreed fact in *Arthur Murray* '...that according to established accounting and commercial principles, in the case of a business either selling goods or supplying services, amounts received in advance of the goods being delivered or the services being supplied are not regarded as income' (at CLR 320). The High Court saw no reason to differ from accountants and commercial men on the point (at CLR 320) and, accordingly, decided in favour of the taxpayer's method of bringing its fee income to account for tax purposes.

25. The essence of the matter in relation to prepayments for services to be rendered in the future is evident in two key passages from the High Court's decision.

26. After discussing the principle in *The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited* (1938) 63 C.L.R. 108) (*Carden's case*) where, because of the uncertainty of receipt inherent in the circumstances of the earning, actual receipt had to be added to earning in order to find income, their Honours said (supra at CLR 319):

> 'Likewise, as it seems to us, in determining whether actual earning has to be added to receipt in order to find income, the answer must be given <u>in the light of the necessity for earning which is inherent in the circumstances of the receipt</u>.' (Underline added)

27. The 'necessity for earning' was addressed by the No. 2 Board of Review in *Case B47* 70 ATC 237; (1970) 15 CTBR (NS) 714 *Case 109* and again in *Case B51* 70 ATC 253; (1970) 15 CTBR (NS) 736 *Case 113*. In ATC *Case B47*/CTBR (NS) *Case 109* the taxpayer had agreed to let certain property with rental income for the 10 year lease being payable in advance. In the event of early termination of the lease by the taxpayer as lessor, otherwise than by reason of the lessee's default or breach, the taxpayer was liable to refund an appropriate proportion of the prepaid rent. The Commissioner treated the prepaid rental as fully assessable in the year of receipt. However, the majority

of the Board of Review held that the taxpayer was entitled to accrue the prepaid rental income on a weekly basis over the expired portion of the lease. ATC *Case B51*/CTBR (NS) *Case 113* also involved prepaid rental income and the facts were similar to those in ATC *Case B47*/CTBR (NS) *Case 109* except that the lease provided for the rent to be paid in advance 'without any deduction or abatement whatever'. The majority of the Board of Review in that case confirmed the Commissioner's amended assessment and held that the taxpayer had derived the whole prepaid rental income in the year of receipt.

28. The approach taken by Mr Davies (Member, and now Davies J of the Federal Court) in ATC *Case B47*/CTBR (NS) *Case 109* (supra at ATC 239; CTBR (NS) 717) and *Case B51* 70 ATC 253; (1970) 15 CTBR (NS) 736 *Case 113*, consistent with the High Court in *Arthur Murray*, was to treat income as not being earned until the liability to effect a refund has in practical terms been extinguished. In ATC *Case B51*/CTBR (NS) *Case 113*, Mr Davies indicated the importance of refundability when he contrasted the circumstances surrounding the prepayments in both cases (supra at ATC 254; CTBR (NS) 738):

> 'The distinction between that case (ATC *Case B47*/CTBR (NS) *Case 109*) and this, however, lies in the fact that the lease agreement there provided for the repayment by the landlord to the tenant, in certain circumstances, of any unexpired proportion of the rental calculated at the weekly rate. That term of the agreement supported a view that the whole of the rental paid in advance did not come home to the taxpayer when received by him so as to constitute income derived at the time of receipt. In the present case, however, B (the lessor), was under no obligation to refund any part of it - *Matthey v. Curling* (1922) 2 AC 180. There is, therefore, no ground for a view that B did not derive the whole of the rent when it was paid to him.' (Underline added)

29. In the second key passage from its decision in *Arthur Murray*, the High Court (supra at CLR 319) also specified, as one of 'the circumstances of the receipt' the possible obligation to refund:

> '...the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it would be out of accord with the realties of the situation to hold, while the

possibility remains, that the amount received has the quality of income derived by the company.' (Underline added)

30. What therefore appears to have been crucial to the High Court's reasoning in the above passage is the possibility of a refund 'should the agreed *quid pro quo* not be rendered in due course'.

31. The decision of the High Court in *Arthur Murray* should only be applied in the context of the supply of goods or services, and in situations where the receipt of a prepayment is subject to a condition that would render it refundable to the payer 'in practical terms'. It is our view, however, that the reference by the High Court in *Arthur Murray* to repayment 'even by way of damages' does not apply to a financial institution lending at interest to its clients. The possibility of damages for wrongful termination of a loan by a financial institution is not a relevant contingency in the context of the principle set out above.

32. It follows that where a borrower pays interest in advance for funds lent by a financial institution, and the loan agreement under which the funds are lent does not provide the borrower with any right to repayment of prepaid interest, then the interest income has 'come home' to the financial institution and is derived at the time of receipt. On the other hand, where the relevant loan agreement provides for the contingency of a refund of prepaid interest to the borrower in light of early repayment of the loan then the financial institution should accrue the prepaid interest over the period to which the interest relates.

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- ITAA 82KZM
- ITAA 159GP(1)
- ITAA Part IVA

case references
- Case B47 70 ATC 237; (1970) 15 CTBR(NS) 714 Case 109
- Case B51 70 ATC 253; (1970) 15 CTBR (NS) 736 Case 113
- Arthur Murray (NSW) Pty Limited v. FC of T (1965) 114 CLR 314
- Country Magazine Pty Limited v. FC of T (1968) 117 CLR 162

- The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited (1938) 63 C.L.R. 108)
- Commissioner of Inland Revenue v. The National Bank of New Zealand 77 ATC 6001; (1977) 7 ATR 282
- Willingale (HM Inspector of Taxes) v. International Commercial Bank Limited (1978) 52 TC 242