TR 1999/19 - Income tax capital gains: treatment of forfeited deposits

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This document has changed over time. This is a consolidated version of the ruling which was published on *11 October 2000*

Taxation Ruling
Income tax: capital gains: treatment of forfeited deposits

Contents Para

Preamble

*The number, subject heading, **Class of person/arrangement**, **Key terms**, **Ruling** and **Date of effect** parts of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. 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.*

[Note: This is a consolidated version of this document in that it has added the content of an Addendum to the end of the document.]

What this Ruling is about

1. This Ruling explains the capital gains tax ('CGT') consequences of:

(a) the receipt by a vendor of a forfeited deposit, forfeited instalments of the purchase price and damages; and

(b) the payment by a purchaser of a deposit that is forfeited;

and considers matters raised by the decision of the Full Court of the Federal Court of Australia in *FC of T v. Guy* 96 ATC 4520; (1996) 32 ATR 590 ('the *Guy* case') and related issues.

Class of person/arrangement

2. This Ruling applies to a vendor who receives a deposit under a contract for the sale of real estate (or receives a deposit pre-contract) and, as a result of the contract being terminated, a purchaser or prospective purchaser forfeits the deposit and the vendor becomes entitled to retain the deposit. It also applies to instalments of the purchase price that are forfeited and retained by a vendor and to damages received by a vendor as a result of a defaulting purchaser's breach of contract.

3. This Ruling also considers whether a defaulting purchaser is entitled to a capital loss for a forfeited deposit.

4. This Ruling does not consider:

- the application of section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA97') to a vendor recipient; or
- the application of section 8-1 to a defaulting purchaser.

Cross references of provisions

5. References in this Ruling are to the ITAA97 unless otherwise indicated. The following table provides cross references between the provisions of the ITAA97 dealt with in this Ruling and the corresponding provisions of the *Income Tax Assessment Act 1936* ('ITAA36').

ITAA97	ITAA36
section 6-5	subsection 25(1)
section 8-1	subsection 51(1)
section 104-10	subsection 160M(1)
subsection 104-10(2)	subsection 160M(1)
subsection 104-25(1)	paragraph 160M(3)(b)
paragraph 104-25(1)(c)	paragraph 160M(3)(b)
subsection 104-25(2)	subsections 160U(3), 160U(4)
section 104-35	subsections 160M(6), 160M(6A)
paragraph 104-35(5)(b)	subsection 160MA(2)
section 104-150	subsection 160ZZC(12)
subsection 104-150(2)	paragraphs 160ZZC(12)(a), 160ZZC(3)(a)
section 104-155	subsection 160M(7)
subsection 108-5(1)	paragraph 160A(a)
section 109-5	subsection 160M(6B)
subsection 109-5(1)	subsection 160M(6B)
subsection 109-5(2)	subsection 160M(6B), subparagraphs 160U(6)(a)(i), 160U(6)(b)(i)
Division 110	section 160ZH

subsection 110-25(2)	paragraphs 160ZH(1)(a), 160ZH(2)(a), subsection 160ZH(4)
subsection 110-25(3)	subsections 160 ZH(1), 160ZH(2)
paragraph 110-25(3)(a)	paragraphs 160ZH(1)(b), 160ZH(2)(b)
paragraph 110-25(3)(b)	paragraph 160ZH(1)(e), 160ZH(2)(e)
section 110-35	subsections 160ZH(5), 160ZH(7)
section 112-20	subsection 160ZH(9)
subsection 112-20(1)	paragraph 160ZH(9)(a)
subsection 112-20(3)	paragraph 160M(6B)(b)
subsection 116-20(1)	subsection 160ZD(1)
paragraph 116-20(1)(a)	paragraph 160ZD(1)(a)
section 116-25	
subsection 116-30(1)	paragraph 160ZD(2)(a)
subparagraph 116-30(3)(a)(i)	paragraph 160ZD(2B)(a)
section 118-110	subsection 160ZZQ(12)
paragraph 118-110(2)(b)	subsection 160ZZQ(12)
Subdivision 122-A	section 160ZZN
Subdivision 126-A	section 160ZZM
section 126-5	section 160ZZM
Subdivision 126-B	section 160ZZO
Division 128	section 160X

Key terms

6. For the purposes of this Ruling the following terms are used:

Most relevant asset approach

The most relevant asset approach, in the context of this Ruling, has the meaning in paragraph 41 of this Ruling. It may be the real estate the subject of the contract of sale, the contractual rights or the right to sue.

Underlying asset

The underlying asset is the real estate that was the subject of the contract for sale which has fallen through.

Continuum of events

The meaning of the term 'continuum of events' is set out in paragraph 16 of this Ruling.

Contractual rights

The term 'contractual rights' refers to the bundle of rights acquired under a contract by a vendor or a purchaser. Refer in particular to paragraphs 69 and 70 of this Ruling.

25 June 1992 amendments

The amendments to section 160A and subsections 160M(6) and 160M(7) of the ITAA36, made by the *Taxation Laws Amendment Act (No 4) 1992*, effective on and from 26 June 1992.

Ruling

CGT event H1 in section 104-150 (about forfeitures of deposits)

7. Entry into a standard contract for sale of real estate constitutes the making of an actual contract of sale. The Full Federal Court in the *Guy* case held that such a contract is not a 'prospective purchase or other transaction' for the purposes of subsection 160ZZC(12) of the ITAA36. CGT event H1 in section 104-150, which deals only with prospective sales or other transactions, therefore does not happen if a deposit is forfeited under an actual contract for sale. However, we consider that other CGT provisions apply with the effect that a forfeited deposit is assessable as a capital gain in certain circumstances.

8. It is unlikely that a deposit paid under a prospective sale, such as a holding deposit paid pre-contract, would be subject to forfeiture. However, if this does occur, we consider CGT event H1 in section 104-150 happens. If section 118-110 (main residence exemption) also applies, the capital gain or capital loss is disregarded.

Most relevant asset approach

9. If:

(a) a deposit is received by a vendor and is then forfeited; and

(b) the forfeiture occurs as part of a 'continuum of events' (see paragraphs 16 to 19 of this Ruling) constituting a later disposal of the real estate the subject of the earlier contract of sale ('the underlying asset');

the forfeited deposit forms part of the capital proceeds from the later disposal. In other words, the forfeited deposit takes on the same character as the sale proceeds for the underlying asset. In this case, the underlying asset is the most relevant asset.

10. It follows that, if the underlying asset was acquired by the vendor before 20 September 1985 or is subject to the main residence exemption, there are no CGT consequences for the receipt of the forfeited deposit. Refer to **Examples 1** and **2** in this Ruling.

11. If the underlying asset was acquired by the vendor on or after 20 September 1985 (and is not subject to the main residence exemption), the forfeited deposit adds to a capital gain or reduces a capital loss made on any later disposal of the underlying asset, provided the forfeiture occurred as part of a 'continuum of events' which constituted the disposal of the underlying asset. Refer to **Example 3** in this Ruling.

Contractual rights as the most relevant asset

12. Conversely, if there is no later disposal of the underlying asset, or any later sale of the underlying asset does not occur within a 'continuum of events' constituting the disposal of that asset, the forfeited deposit can not form part of the capital proceeds from a disposal of that asset. In the former case, it does not take on the same character as the sale proceeds for the underlying asset because there has been no disposal of that asset. In the latter case, it does not take on the same character as the sale proceeds for the underlying asset because the forfeited deposit is not material to any later sale of the asset which does not occur within a 'continuum of events' constituting its disposal. In both of these cases, the vendor's bundle of contractual rights is the most relevant asset. There has been an acquisition and an ending of ownership of these contractual rights by the vendor (CGT event C2 in section 104-25 - about cancellations, surrenders and similar endings of intangible CGT assets). As a result, the vendor makes a capital gain equal to the amount of the forfeited deposit (less any incidental costs included in the cost base). This means that a forfeited deposit received in relation to a main residence or an asset

acquired before 20 September 1985 may be assessable as a capital gain. Refer to **Example 4** in this Ruling.

Forfeited instalments of the purchase price

13. If a contract for sale of real estate is terminated and a deposit is forfeited, instalments paid under the contract before its termination may also be forfeited. If a vendor becomes entitled to retain part or all of an instalment, or lawfully applies instalment moneys towards the satisfaction of damages, this Ruling applies to a forfeited instalment in the same manner as it applies to a forfeited deposit. That is, if the instalment is forfeited within a 'continuum of events' constituting the disposal of the underlying asset, a validly forfeited instalment forms part of the capital proceeds from the later disposal of the underlying asset. If the instalment is not forfeited within a 'continuum of events' constituting the disposal of the underlying asset, the forfeited instalment represents capital proceeds from the ending of the vendor's ownership of a right to seek compensation (CGT event C2).

Damages

14. If damages are received as part of the 'continuum of events' constituting the later disposal of the underlying asset, the damages also form part of the capital proceeds from that later disposal. This Ruling, therefore, applies to the receipt of damages in the same manner as it does to the receipt of a forfeited deposit. If there is no relevant 'continuum of events', the damages represent capital proceeds from CGT event C2 happening to the vendor's right to seek compensation, with the same consequences as for forfeited instalments.

CGT event H2 in section 104-155 (about receipts for events relating to CGT assets)

15. Generally speaking, a forfeited deposit or an amount of damages is capital proceeds from a disposal of the underlying asset or capital proceeds from CGT event C2 happening to the contractual rights or the right to seek compensation. CGT event H2 cannot happen in these circumstances. CGT event H2 may only happen if the amount received does not relate to any CGT event happening to any of the above assets: paragraph 102-25(3)(b).

What is a 'continuum of events'?

16. What is a 'continuum of events' which constitutes a disposal of an underlying asset? For a relevant 'continuum of events' to exist,

there must be an earlier contract to sell the underlying asset, forfeiture of a deposit and a later bona fide disposal of the underlying asset. It is also necessary, in our view, for continuous and reasonable attempts to be made to resell the underlying asset (for example, real estate) after the earlier contract has fallen through, which end in this later disposal of the real estate. Refer to **Examples 5** and **6** in this Ruling.

17. While no temporal requirement exists, the longer the period between forfeiture and later disposal, the more difficult it is to show a 'continuum of events' which constitutes a disposal of the underlying asset. For example, it is difficult to show a 'continuum of events' of more than 2 years from the date of forfeiture under the earlier contract.

18. If there is no longer a 'continuum of events' which constitutes a disposal of an underlying asset (e.g., after a 2 year period), a vendor is required to amend their income tax return for the earlier year in which the forfeiture occurred and include the forfeited deposit as assessable income. This is on the basis that the vendor's contractual rights are the most relevant asset and that there has been an acquisition and an ending of ownership of their contractual rights (CGT event C2). Refer to **Example 7** in this Ruling.

19. We consider the words, 'uninterrupted sequence of transactions' in paragraph 118-110(2)(b), broadly speaking, have the same meaning as the phrase 'continuum of events' as used in this Ruling.

Does a defaulting purchaser make a capital loss?

20. Application of the contractual rights approach to a defaulting purchaser may give rise to a capital loss in certain circumstances. Whether a capital loss arises depends on the amount of the cost base of the purchaser's contractual rights and the capital proceeds from the ending of the purchaser's ownership of those rights.

21. If a purchaser forfeits a deposit, either CGT event C1 in section 104-20 (about a loss or destruction of a CGT asset) or CGT event C2 in section 104-25 happens, whichever CGT event is the more specific to the circumstances of the case: subsection 102-25(1).

22. No consideration is usually received by a purchaser on the termination of their contractual rights. If no capital proceeds are received from a CGT event, generally the purchaser is taken to have received the market value of the CGT asset that is the subject of the event (subsections 116-30(1) and 116-30(3A)).

23. The market value of the right to a transfer of the real estate is the value of the real estate less the amount still to be paid. If the market value of the real estate at the time of termination of the

contract has dropped below the balance payable on completion of the contract, the market value of the contractual rights is nil and a bona fide purchaser is entitled to a capital loss, being the amount of the deposit forfeited plus incidental costs.

24. If CGT event C1 is the most specific CGT event, the market value substitution rule does not apply and a bona fide purchaser is entitled to a capital loss of the amount of the deposit forfeited plus incidental costs, regardless of the market value of the contractual rights or the underlying real estate. If CGT event C2 is the most specific CGT event, the market value substitution rule applies and a bone fide purchaser might not make a capital loss.

Summary of this Ruling for a vendor

25. The following table summarises the CGT consequences of the receipt by a vendor of a forfeited deposit, forfeited instalments of purchase price and damages.

	Deposits paid pre contract, i.e., holding deposits	**Forfeited deposits under actual contracts**	**Damages and forfeited instalments**
Main residence			
Forfeiture within continuum of events	**Not assessable** CGT event H1 (s104-150) happens but capital gain is disregarded s118-110	**Not assessable** CGT event H1 (s104-150) does not happen and under s118-110 any capital gain arising under any other provision is disregarded	**Not assessable** s118-110
Forfeiture not within continuum of events	**Assessable** CGT event H1 (s104-150)	**Assessable** CGT event C2 (s104-25) happens to the vendor's contractual rights	**Assessable** CGT event C2 (s104-25) happens to the vendor's right to seek compensation
Asset acquired pre 20/9/85 (not a main residence)			
Forfeiture within continuum of events	**Assessable** CGT event H1 (s104-150)	**Not assessable**	**Not assessable**

Forfeiture not within continuum of events	**Assessable** CGT event H1 (s104-150)	**Assessable** CGT event C2 (s104-25) happens to the vendor's contractual rights	**Assessable** CGT event C2 (s104-25) happens to the vendor's right to seek compensation
Asset acquired after 20/9/85 (not a main residence)			
Forfeiture within continuum of events	**Assessable** CGT event H1 (s104-150)	**Assessable** CGT event A1 (s104-10)	**Assessable** CGT event A1 (s104-10)
Forfeiture not within continuum of events	**Assessable** CGT event H1 (s104-150)	**Assessable** CGT event C2 (s104-25) happens to the vendor's contractual rights	**Assessable** CGT event C2 (s104-25) happens to the vendor's right to seek compensation

Date of effect

26. 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 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). Also, if a taxpayer has obtained a more favourable private ruling (whether legally or administratively binding) this Ruling applies to that taxpayer to the extent of the inconsistency only from its date of issue.

Effect of this Ruling on Taxation Ruling TR 94/29

27. The approach outlined in TR 94/29 (paragraphs 13 to 20) is consistent with the decision in the *Guy* case. TR 94/29 provides that if a contract for the sale of land falls through, a capital gain may arise on the receipt of damages, with the relevant asset being either the right to seek compensation or the notional subsection 160M(7) (of the ITAA36) asset. It is only if the damages are received as part of a 'continuum of events' that constitute the disposal of a vendor's main residence, or of an asset acquired before 20 September 1985, that an exemption may apply.

28. To the extent of this inconsistency, this Ruling takes precedence over TR 94/29. In particular, paragraph 17 of TR 94/29

states the relevant asset is either the right of action or the notional asset. If damages are received as part of a 'continuum of events' that constitute the disposal of an underlying asset, the relevant asset is, in accordance with this Ruling, the underlying asset. Paragraphs 13 and 14 of this Ruling are more favourable to taxpayers than paragraphs 16 and 17 of TR 94/29. In accordance with paragraph 12 of TR 92/20, paragraphs 13 and 14 of this Ruling have both a past and future application (subject to the statutory limits of section 170 of the ITAA36).

29. Treating a vendor's contractual rights as the most relevant asset in certain circumstances as outlined in this Ruling should not be taken to be inconsistent with the discussion in paragraph 43 of TR 94/29 about the decision in *Zim Properties Ltd v. Proctor (HM Inspector of Taxes)* (1984) 58 TC 371 and subsection 160MA(2) of the ITAA36. That discussion clearly presumes the sale of the underlying asset in saying that the land is the relevant asset being disposed of and not the contractual rights.

Explanations

General aspects of the Ruling

The Guy decision

30. The issue whether a forfeited deposit retained by a vendor of real estate is assessable under the CGT provisions was considered by the Full Federal Court in *FC of T v. Guy* 96 ATC 4520; (1996) 32 ATR 590.

31. Briefly, the facts of the *Guy* case are as follows. The taxpayers exchanged contracts on the sale of their principal residence for a sale price of $906,000. A deposit of $45,300 was received. The purchasers failed to complete the purchase in accordance with the contract. The contract was terminated and the deposit was forfeited. The taxpayers also sued the purchasers for damages and this claim was settled in the sum of $65,000. Later, the taxpayers resold their residence to a new purchaser for $830,000 being the market value at the time of sale.

32. At issue was whether the forfeited deposit and the damages were assessable under the CGT provisions of the ITAA36. In particular, did section 160ZZC of Part IIIA apply to deem the forfeited deposit to be in respect of the grant of an option and, therefore, become subject to CGT and, if so, did the principal residence exemption in section 160ZZQ then apply to exempt the gain.

33. The Court concluded that although the term 'prospective purchase' in subsection 160ZZC(12) would bring within the

subsection's scope the forfeiture of a holding deposit, subsection 160ZZC(12) does not apply to the forfeiture of a deposit paid under an actual contract for purchase. The Court also concluded that the falling through of the original sale, the forfeiture of the deposit and the later resale were all part of a 'continuum of events' leading to the disposal of the taxpayer's principal residence. Accordingly, the exemption under subsection 160ZZQ(12) would have applied in any case.

34. The Court also concluded that the recovery of damages formed part of the 'continuum of events' which constituted the disposal of the dwelling so as to be included as something 'in respect of' that disposal. Accordingly, it was also exempt under subsection 160ZZQ(12).

What is a deposit?

35. Contracts for the sale of real estate normally provide for the payment of a deposit (usually 10%, although other amounts may be agreed), payable at the time of entering into the contract and the balance of the purchase price being payable on completion or by instalments. The deposit paid by a purchaser under a binding contract for sale serves several purposes. It is an earnest given to bind the bargain; it is a guarantee that the purchaser means business; and, on completion, it becomes part payment of the purchase price (see *Howe v. Smith* [1884] 27 Ch D 89 at 101; *Brien v. Dwyer and Another* (1978) 141 CLR 378 at 392).

36. Broadly, if a purchaser defaults the vendor is entitled to terminate the contract and the purchaser forfeits the deposit. The deposit is forfeited to the vendor at the time of termination of the contract.

CGT event H1 in section 104-150 (about forfeitures of deposits)

37. The Full Federal Court in the *Guy* case considered that entry into a standard contract of sale (whether by exchange of contracts or both parties signing the one contract) constitutes the making of an actual contract of sale. It held that subsection 160ZZC(12) of the ITAA36 does not apply to a deposit forfeited under an actual contract for sale. Accordingly, CGT event H1 in section 104-150 also does not happen to a deposit forfeited under an actual contract for sale. Nevertheless, other CGT provisions may apply with the effect that a forfeited deposit is assessable in certain circumstances.

38. It is unlikely that a deposit paid under a prospective sale, such as a holding deposit paid pre-contract, would be subject to forfeiture because a prospective purchaser is generally entitled to a return of their holding deposit.

39. If a holding deposit under a prospective sale is forfeited, CGT event H1 happens and the prospective vendor makes a capital gain if the deposit is more than the expenditure incurred in connection with the prospective sale: see subsection 104-150(3). If section 118-110 (main residence exemption) also applies, the capital gain or capital loss is disregarded.

40. The time of the CGT event is when the deposit is forfeited (subsection 104-150(2)). (See also *Case 32/94* 94 ATC 298; *AAT Case 9538* (1994) 28 ATR 1230). A prospective vendor makes a capital gain or capital loss in the year in which the deposit is forfeited.

Explanation of the most relevant asset approach

41. The most relevant asset approach, in the context of this Ruling, is the process of analysing all the possible assets of the vendor in order to determine the asset to which the forfeited deposit, forfeited instalment or damages most directly relates.

42. If a forfeited deposit is received by a vendor, and the forfeiture occurs as part of the 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit forms part of the capital proceeds, under subsection 116-20(1), from the later disposal. In other words, the forfeited deposit takes on the same character as the sale proceeds of the underlying asset and is, therefore, part of the capital proceeds from the later disposal. In this case, the underlying asset is the most relevant asset.

43. If a capital gain or loss you make on an underlying asset is disregarded, e.g., the main residence exemption, there are no CGT consequences for a forfeited deposit, providing the forfeiture occurred as part of a 'continuum of events' which constituted the disposal of the underlying asset. Nor are there any CGT consequences for a forfeited deposit if the underlying asset was acquired before 20 September 1985 and the forfeiture occurred as part of a 'continuum of events' which constituted the disposal of the underlying asset.

44. If the underlying asset was acquired by the vendor on or after 20 September 1985 and is not subject to the main residence exemption, the forfeited deposit adds to a capital gain or reduces a capital loss made on the later disposal of the underlying asset, provided the forfeiture occurred as part of a 'continuum of events' constituting the disposal of the underlying asset. The deposit is simply taken to be part of the capital proceeds from the disposal.

45. Paragraph 116-20(1)(a) states that capital proceeds from a CGT event include:

> 'the money you have received, or are entitled to receive, in respect of the event happening'.

46. The expression 'in respect of' denotes a relationship or connection between two things: *State Government Insurance Office v. Rees and Another* (1979) 144 CLR 549 at 559; 26 ALR 341 at 351 per Mason J. The phrase is capable of describing relationships over a wide range of degrees of proximity: the meaning to be attributed to it on a particular occasion depends on the context: *FC of T v. Tully Co-operative Sugar Milling Association Limited* 83 ATC 4495 at 4506; (1983) 14 ATR 495 at 508. The words 'in respect of', in their context in paragraph 116-20(1)(a), have a meaning wide enough to include a forfeited deposit in the capital proceeds from the disposal of an underlying asset if the forfeiture of the deposit and the later disposal occur as parts of a 'continuum of events'.

47. If there is no later disposal of the underlying asset, or any later sale of the underlying asset did not occur within a 'continuum of events' constituting the disposal of that asset, the forfeited deposit cannot form part of the capital proceeds from a disposal of the underlying asset. In the former case, it does not take on the same character as the sale proceeds for the underlying asset because there has been no disposal of that asset. In the latter case, it does not take on the same character as the sale proceeds for the underlying asset because the forfeited deposit is not material to any later sale of the asset which does not occur within a 'continuum of events' constituting its disposal. In both of these cases, the vendor's bundle of contractual rights is the most relevant asset. There has been an acquisition and an ending of ownership (CGT event C2) of contractual rights by the vendor. As a result, the vendor can make a capital gain if the capital proceeds from the ending (the forfeited deposit) are more than the cost base of the contractual rights. This means that a forfeited deposit received in relation to a main residence or real estate acquired before 20 September 1985, in some circumstances, can constitute an assessable capital gain.

Taxation Ruling TR 95/35 and the 'continuum of events' approach

48. In essence, the most relevant asset approach taken in this Ruling combines the underlying asset approach outlined in Taxation Ruling TR 95/35 with the 'continuum of events' approach used in the *Guy* case. As TR 95/35 points out, if compensation is received for the disposal of an underlying asset, the compensation represents consideration received in respect of the disposal of that asset and not the right to seek compensation, i.e., if the underlying asset has been disposed of, the compensation receipt is treated as part (or all) of the disposal consideration. If there has been no disposal and no permanent damage or permanent reduction in value of an underlying asset, the compensation relates to the disposal of the right to seek compensation.

49. This is consistent with the approach taken in this Ruling in that, if a forfeited deposit is received as part of a 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit is treated as part of the capital proceeds from the disposal of the underlying asset. If any later sale of the underlying asset does not occur within a 'continuum of events' constituting the disposal of that asset or there is no later disposal, we do not look through to the underlying asset but treat the bundle of contractual rights as the most relevant asset. The 'continuum of events' approach used in the *Guy* case assists in determining whether a forfeited deposit is received in respect of the disposal of an underlying asset.

What is a continuum of events?

50. The Full Federal Court in the *Guy* case used the phrase 'continuum of events' in its *obiter dicta* on the principal residence exemption (96 ATC at 4531; 32 ATR at 601), viz;

> 'In our opinion, the "disposal" of the taxpayers' dwelling should be characterised as starting with the sale to the Starlings and as including both the falling through of that sale and **the completed sale** to the Rookes **very soon after**. There was, we think, **no interruption** in that continuum of events which might justify not treating all that took place as not being " ... in respect of the disposal of the dwelling" within the meaning of sub-s 160ZZQ(12).
>
> Furthermore, that view is consonant with what would **commonly be regarded** as the "disposal of a dwelling". A dwelling is put on the market, a contract is made, the purchasers default, the dwelling is put **straight back** on the market and then it is **sold**. It must follow, in our view, that the exemption provided by Division 18 extended to the forfeiture of the deposit which occurred as part of this continuum. The forfeiture may fairly be regarded as part of the process of disposal of the dwelling, rather than as an event **divorced from that process** ....' (emphasis added).

51. *The Macquarie Dictionary* defines the word 'continuum' as 'a continuous extent, series or whole'. It defines 'continuous' as 'having the parts in immediate connection, unbroken. Uninterrupted in time; without cessation'.

52. Having regard to the ordinary meaning of the word 'continuum', and the use by the Court in the *Guy* case of the words emphasised above, for a 'continuum of events' to exist there must be an earlier contract to sell the underlying asset, forfeiture of a deposit and a later bona fide disposal of the underlying asset. In addition, we consider it is necessary for there to be continuous, unbroken and

uninterrupted reasonable attempts to resell the real estate after the falling through of an earlier contract of sale which end in this later disposal.

53. Notwithstanding this, a delay in immediately placing the real estate back on the market after an earlier sale has fallen through may not, in certain circumstances, break the 'continuum of events'. For example, a delay that is caused by the time taken to consult a legal adviser as to the possibility of commencing legal action against the defaulting purchaser, or to consult a real estate agent for the purpose of determining an appropriate marketing strategy to resell the real estate, would not generally break the 'continuum of events'. This is providing the real estate is placed back on the market as soon as possible after such advice has been obtained and continuous and reasonable attempts are then made to resell the real estate.

54. Also, if the commercial reality is that a vendor needs to carry out renovations or even subdivide land to effect a resale of the real estate, this action of itself, does not break the 'continuum of events', providing always the vendor retains their commitment to resell the real estate and the other requirements of a 'continuum of events' are met. Refer to **Examples 8** and **9** in this Ruling.

55. If no acceptable reason exists for a delay in placing the real estate back on the market, such a delay breaks the 'continuum of events'. The consequences of this are as outlined in paragraph 12 above.

56. If the real estate is immediately placed back on the market but at an above-market price, or if it is ostensibly back on the market but no real attempts are made to sell it, it is likely that the vendor does not have the required bona fides and commitment to sell and this also results in a break of the 'continuum of events'. It is also likely, in this situation, that there would be an unduly lengthy disposal period (or no disposal) which would further indicate the lack of the required continuity and bona fides.

57. In some situations, the vendor may pursue an action for damages after terminating a contract and before attempting to resell the real estate. This does not break a 'continuum of events', providing the other requirements of a 'continuum of events' are met, if such action is actively and continuously pursued until finality or settlement and continuous and reasonable attempts are then made to resell the real estate and it is, in fact, resold.

58. Alternatively, a vendor may resell the real estate before commencing legal action. If the real estate is resold within a 'continuum of events' and legal action is then commenced and pursued continuously until resolution, any damages received form part of the capital proceeds from the disposal of the underlying asset.

59. If a forfeited deposit has been retained by a vendor and the asset is then subject to an 'involuntary' rollover, such as on death (Division 128) or marriage breakdown (Subdivision 126-A), the rollover relief available effectively also takes into account the forfeited deposit, providing the requirements of a 'continuum of events' are satisfied up to the time of rollover. Refer to **Example 10** in this Ruling.

60. If a forfeited deposit has been retained by a vendor and the asset is then transferred to a related entity - so that Subdivision 122-A (rollover to a wholly owned company) or Subdivision 126-B (rollover to wholly owned group company) rollover relief would be attracted - it is likely that this breaks the 'continuum of events'. Such a transfer evidences a new way of holding an asset and is not consistent with a continuing intention and effort to resell the asset. Refer to **Example 11** in this Ruling.

61. In addition to the requirements that:

(a) there be a later bona fide disposal of the real estate; and

(b) continuous and reasonable attempts be made to resell the real estate which end in this later disposal;

in determining whether a 'continuum of events' has or has not been broken, it is appropriate to have regard to a time limit within which the later disposal needs to occur. This is because it is often the case that no later disposal ever occurs. This has primarily been due to no, or discontinued, attempts being made to resell the real estate. We have identified some cases in which no later disposal has ever occurred despite an elapsed period of, in some cases, 8 to 10 years. Obviously, in these circumstances the bundle of contractual rights, rather than the underlying asset, is the most relevant asset.

62. We consider that a period of 2 years is an appropriate benchmark. It appears, based on cases examined and discussions held, that if continuous and reasonable attempts are made to resell the property, most properties are actually resold within 2 years. Two years is, therefore, a commercially realistic period.

63. Even if there are on-going attempts to resell the real estate, its later disposal needs to occur within 2 years from the date of forfeiture under the earlier contract for it to continue to be the most relevant asset. If this does not occur, vendors may not reasonably be in a position to rely on a 'continuum of events', in which case they should amend their income tax returns for the earlier year in which the forfeiture occurred. The amendment would include the forfeited deposit as a capital gain on the basis that there has been an ending of ownership of contractual rights. Of course, if the 'continuum of events' is broken before the end of the 2 year period, vendors are

required to amend the relevant year's return at that time and not wait until the 2 year period has expired.

64. It is, however, open to a vendor to show that, on a later resale of the underlying asset outside the 2 year period and providing continuous and reasonable efforts were made to resell the real estate, a 'continuum of events' was not broken. If so, they could request an amendment at that time to exclude the forfeited deposit. However, in the first place, it would be prudent for them to include the forfeited deposit in assessable income in the relevant income year once the 2 year period has elapsed. If a vendor considers that the 'continuum of events' might extend past the four year amendment time limit set out in subsection 170(3) of the ITAA36, they should lodge a 'protective objection'.

65. A vendor may become liable for the payment of interest under section 170AA if they are required to amend an earlier year's return. However, although each case is dealt with on its own merits, we expect that the discretion in subsection 170AA(11) would be exercised to remit the interest in full if requests for amendment are lodged and, if relevant, self amendments are made within a reasonable time after the expiry of the 2 year period.

66. In most cases, we would consider a period of one month after the expiry of the 2 year period to be reasonable for this purpose. However, we accept that there may well be circumstances where a vendor can establish that a longer period is reasonable. One exception to this is if there has clearly been a break in the 'continuum of events', for example, if real estate is simply not put back on the market after a contract has fallen through. In this case, the forfeited deposit should be included in assessable income in the relevant income year. No remission of interest is likely in these circumstances.

67. Although in the *Guy* case the Court referred to 'the **completed** sale ... very soon after' (emphasis added), it is appropriate that the 2 year period be measured from the date of forfeiture of the deposit under the earlier contract for sale to the date of contract of the later resale of the real estate. Using the date of settlement of the later resale, instead of the date of contract, would be complicated by delayed settlements that are sometimes negotiated. However, if it appears a vendor is attempting to manipulate the period and defer a tax liability by purporting to enter into a contract of sale with deferred settlement terms (which ultimately may not be completed), the later contract is likely to be disregarded.

Explanation of the contractual rights approach

68. As noted above, if any later sale of the underlying asset does not occur within a 'continuum of events' constituting the disposal of that asset or there is no later disposal:

(a) the contractual rights of the vendor are the most relevant asset;

(b) there has been an acquisition and an ending of ownership of these contractual rights by the vendor; and

(c) the forfeited deposit is subject to the CGT provisions.

General concepts

After the 25 June 1992 amendments

CGT asset

69. The bundle of contractual rights a vendor acquires under a contract of sale is a CGT asset for the purposes of the CGT provisions: subsection 108-5(1). The explanatory memorandum to the Taxation Laws Amendment Bill (No 4) 1992 recognises that rights under a contract are an example of an incorporeal asset.

70. These rights include a right to purchase money, a charge or lien on the real estate for the security of that purchase money and a right to retain possession of the real estate until the purchase money is paid, in the absence of an express contract as to the time of delivering possession (see *Lysaght v. Edwards* [1876] 2 Ch D 499 and *Australian Real Property Law*, A Bradbrook, S MacCallum, A Moore, The Law Book Company Ltd, 1991, at 233).

Acquisition

71. These rights are acquired by a vendor within the meaning of section 109-5. CGT event D1 in section 104-35 (about creating contractual or other rights) happens if someone creates a contractual right or other legal or equitable right in another entity. When a purchaser enters into a contract, they create these rights in the vendor.

72. Subsection 109-5(2), event number D1 specifies when a CGT asset is acquired as a result of a CGT event happening (to someone else). If CGT event D1 happens to the purchaser, the asset is acquired by the vendor when the contract is entered into or the right is created. The contractual rights acquired by the vendor are, therefore, acquired when the contract is entered into.

Cost base

73. The first element of cost base of the vendor's contractual rights includes the market value of any property they gave, or are required to give, in respect of acquiring the rights (paragraph 110-25(2)(b)). Although the vendor may have given property, being contractual rights given to the purchaser to have the real estate transferred, the market value of this property is nil because of the corresponding contractual obligation of the purchaser to pay the purchase price. So, the first element of cost base of the vendor's contractual rights is zero.

74. There may be incidental costs of acquisition in terms of section 110-35 which are included in the second element of the cost base under paragraph 110-25(3)(a). Legal fees incurred by the vendor of the underlying asset (being the one who is acquiring the contractual rights) in entering into the contract are incidental costs of acquisition of the contractual rights if the contract falls through and there is no later disposal within a 'continuum of events'. If a later disposal occurs within a 'continuum of events', or if the contract does not fall through but is completed in the normal manner, we consider that such costs are part of the incidental costs that relate to the disposal of the underlying asset (paragraph 110-25(3)(b), section 104-10).

CGT event

75. If, after a purchaser's default, a vendor terminates the contract and retains the deposit, CGT event C2 in subsection 104-25(1) happens because the vendor's ownership of contractual rights has ended. At the time of termination of the contract, the rights have been subject to a 'release', 'surrender' or 'abandonment'.

76. In some instances, legal action may be commenced by the purchaser to recover the deposit on the basis that, for example, either the vendor was in default or the quantum of the deposit was such that it (or part of it) should be construed as a penalty and, therefore, not be subject to forfeiture.

77. Regardless of the outcome of the legal action, the date of termination of the contract remains the time the CGT event happens to the contractual rights of the vendor. If the action results in the return of the deposit to the purchaser, this does not affect the timing of the CGT event. Rather, it is an issue concerning the quantum of the capital proceeds.

Capital proceeds

78. On a purchaser forfeiting a deposit, the vendor becomes entitled to retain the deposit. Therefore, in terms of subsection 116-20(1), the vendor has received, or is entitled to receive, money in

respect of a CGT event happening. (Before forfeiture, while the contract is still on foot, the deposit is held by the stakeholder pending the completion of the contract.)

Capital gain

79. Thus, there is an acquisition of a CGT asset for a cost base limited to incidental costs and a CGT event happening with capital proceeds equal to the amount of the forfeited deposit. It follows that the forfeited deposit (less the incidental costs) constitutes a capital gain and, therefore, is fully assessable to the vendor.

Operation of paragraph 104-35(5)(b)

80. Does paragraph 104-35(5)(b) preclude CGT event D1 (in section 104-35) happening to the vendor's contractual rights as outlined above? It reads:

> 'CGT event D1 does not happen if:
> (b) the right requires you to do something that is another CGT event that happens to you;'.

81. The short answer is no.

82. If a vendor enters into a contract to sell real estate to a purchaser, the vendor creates a right in the purchaser to require the vendor to transfer the real estate. As discussed in the explanatory memorandum to the Taxation Laws Amendment Bill (No 4) 1992, it is arguable that the vendor has received, as consideration for creating that right, the amount of the consideration payable for the disposal of the real estate. If this is so, section 104-35 would apply to make the whole of the consideration a capital gain to the vendor. This would lead to a situation where the same amount could be capital proceeds from the disposal of the underlying asset (CGT event A1 - section 104-10) and also be capital proceeds from the creation of the contractual rights (CGT event D1 - section 104-35).

83. To avoid this and put the issue beyond doubt, paragraph 104-35(5)(b) prevents CGT event D1 happening on the creation of a right that requires something to be done that is another CGT event that happens.

84. However, it is the contractual rights created by the purchaser in the vendor that we are concerned with, in applying the contractual rights approach outlined above, e.g., the vendor's rights to require payment by the purchaser of the sale proceeds. As the payment of the sale proceeds by the purchaser does not constitute a CGT event, paragraph 104-35(5)(b) does not apply, so that section 104-35 is not precluded from applying.

Before the 25 June 1992 amendments

Asset

85. The bundle of contractual rights of a vendor is of a proprietary nature and is an asset even before the 25 June 1992 amendments.

86. The High Court of Australia in *FC of T v. Orica Limited (formerly ICI Australia Limited)* 98 ATC 4494; (1998) 39 ATR 66 held, unanimously on this point, that rights under a 'Principal Assumption Agreement' (entered into in 1986) were an asset for CGT purposes. Gummow J noted that such rights were created under the general law of contract (at ATC 4518, paragraph 110; ATR 96, paragraph [110]).

87. Rights that are capable in their nature of assumption by third parties are rights of a proprietary character: cf. *The Queen v. Toohey: ex parte Meneling Station Pty Ltd* (1982) 158 CLR 327 at 342-3; Meagher, Gummow and Lehane, *Equity Doctrines and Remedies*, 3rd ed, paragraph 695. However, as the majority in the *Orica* case noted, it is important to bear in mind the statement by Kitto J in *National Trustees and Agency Company of Australasia Limited v. FC of T* (1954) 91 CLR 540 at 583 that '... alienability is not an indispensable attribute of a right of property ...'. In any case, a vendor may lawfully assign their interest under the contract (i.e., their right to the purchase money) to a third party either by way of equitable assignment or legal assignment pursuant to section 12 of the *Conveyancing Act 1919* (NSW) or similar provisions in other States. (See, generally, *Assignment of Choses in Action*, Starke JG, Butterworths, 1972, at 38-40.)

88. A vendor's bundle of contractual rights, in our view, is, therefore, an asset both before and after the 25 June 1992 amendments.

Acquisition

89. Contractual rights created and vested in a vendor before 26 June 1992 are taken by paragraph 160M(5)(c) of the ITAA 36 to have been acquired by the vendor.

CGT event

90. A CGT event may happen to contractual rights acquired before 26 June 1992. If the vendor terminates the contract, for instance, CGT event C2 in subsection 104-25(1) happens to the rights.

Forfeited instalments and damages

Forfeited instalments

91. If a contract for sale of real estate is terminated and the deposit forfeited, it may be the case that instalments paid under the contract before its termination are also forfeited. Whether a vendor is legally entitled to retain the instalments depends on such things as the terms of the contract and the operation of contract and conveyancing law.

92. In general, a defaulting purchaser is entitled to a return of such moneys. A contractual provision that requires one party, on their breach, to forfeit an amount to the other party, is unlawful as being a penalty. This is so unless it can be justified as being a payment of liquidated damages as a genuine pre-estimate of the loss the innocent party will incur (see *Workers Trust & Merchant Bank Ltd v. Dojap Investments Ltd* [1993] AC 573 at 578). The longstanding exception to this is, of course, a deposit paid under a contract for sale.

93. If a vendor seeks to retain an instalment paid under a contract, the purchaser may take legal action seeking recovery of the instalment and/or the vendor may take legal action seeking to obtain damages and retention of the instalment. The legal action may result in the vendor being entitled to retain all or part of the instalment. Such an outcome may also occur if the parties settle their respective actions by entering into an agreement.

94. The retention of instalment moneys, pending the determination of damages, does not of itself give rise to a capital gain. However, if a vendor becomes entitled to retain part or all of an instalment, or lawfully applies instalment moneys toward the satisfaction of damages resulting from the purchaser's breach, this Ruling applies to a forfeited instalment in the same manner as it applies to a forfeited deposit. That is, if the real estate is resold within a 'continuum of events', a validly forfeited instalment forms part of the capital proceeds from the disposal of the underlying asset with the same consequences as outlined in paragraphs 9 to 11 above. Refer to **Example 12** in this Ruling. If any later sale of the underlying asset does not occur within a 'continuum of events' constituting the disposal of that asset, the forfeited instalment represents capital proceeds from the ending of the vendor's ownership of their right to seek compensation. Refer to **Example 13** in this Ruling.

Right to seek compensation

95. A right to seek compensation is a CGT asset (see Taxation Ruling TR 95/35). If a breach of contract occurs, the asset is generally acquired at the time of the breach.

What is the cost base of the asset?

96. The cost base of the right to seek compensation is determined by Division 110. Legal fees and charges connected with the proceedings and incurred during the course of proceedings may be included in the cost base of the asset in terms of subsection 110-25(3) and section 110-35. Section 112-20 cannot apply to give the taxpayer a market value cost base.

When does a CGT event happen?

97. CGT event C2 in subsection 104-25(1) happens when the taxpayer agrees to a release, discharge, satisfaction or surrender of their right to seek compensation. This is at the final point of settlement of the claim, whether in the course of Court proceedings, or in an out of Court arrangement. The time of the event determined by subsection 104-25(2) is the time of entering into the relevant contract or when the asset ends. This may be the entering into the contract, the settlement agreement, or when the Court makes a determination.

98. It follows that, if the right to seek compensation is the most relevant asset, i.e., any 'continuum of events' has been broken, a forfeited instalment is not assessable in the year the contract is terminated but later, when legal action between the parties has been finalised or settled.

99. If an instalment is forfeited by a purchaser to a vendor but no legal action is taken to seek compensation for the purchaser's breach of contract, CGT event C2 does not happen until the vendor's right to seek damages becomes statute barred, i.e., there is an expiry in terms of paragraph 104-25(1)(c).

Damages

100. Whether or not forfeited instalments are involved, a vendor may, on the purchaser's breach, sue for and receive damages. In the *Guy* case, the Court considered (96 ATC at 4531; 32 ATR at 602):

> '... the recovery of the damages also formed part of the process, or continuum of events, which constituted the disposal of the dwelling, so as to be picked up as something "in respect of" that disposal, and accordingly exempt from the operation of Part IIIA'.

101. Accordingly, if damages are received as part of the 'continuum of events' constituting the later disposal of the underlying asset, the damages form part of the capital proceeds from the disposal of the underlying asset. This Ruling, therefore, applies to the receipt of damages in the same manner as it does to the receipt of a forfeited

deposit, with the consequences as outlined in paragraphs 9 to 11 above.

102. If the underlying asset has been resold within a 'continuum of events' but damages are not received until after the resale, the damages still form part of the capital proceeds from the disposal of the underlying asset. If the damages are received in a financial year later than the one in which the underlying asset was resold, then (if a capital gain or loss made on the underlying asset is not disregarded) an amendment of the income tax return for the earlier year is necessary to include the damages as part of the capital proceeds from the disposal of the underlying asset.

103. A vendor may become liable for interest under section 170AA of the ITAA36, if they are required to amend an earlier year's return. However, although each case is dealt with on its own merits, it would be expected that the discretion in subsection 170AA(11) of the ITAA36 would be exercised to remit the interest in full if requests for amendment are lodged and, where relevant, self amendments are made, within a reasonable time after the receipt of the damages. In most cases, we would consider a period of one month after such receipt to be reasonable for this purpose. However, there may well be circumstances where a vendor can establish that a longer period is reasonable.

104. If any 'continuum of events' has been broken, the damages represent capital proceeds from the ending of the vendor's ownership of the right to seek compensation, with the same consequences as for forfeited instalments outlined in paragraphs 94 to 99 above.

Does a defaulting purchaser make a capital loss?

105. Does the law allow a capital loss to a defaulting purchaser? Can a defaulting purchaser obtain a capital loss by the application of the contractual rights approach to the purchaser's contractual rights? In determining this, it is necessary, firstly, to consider the possible application of paragraph 104-35(5)(b).

Paragraph 104-35(5)(b)

106. As noted earlier, there is a question whether paragraph 104-35(5)(b) precludes CGT event D1 in section 104-35 from happening. It provides that, if a right is created in another entity that requires something to be done that is another CGT event that happens, CGT event D1 does not happen to the creation of the right.

107. Thus, if a vendor enters into a contract to sell real estate to a purchaser and, therefore, creates in the purchaser a right to require the vendor to dispose of the real estate, on a literal reading of paragraph

104-35(5)(b), section 104-35 does not apply. The effect of this might be that there is no acquisition of an asset under section 109-5 by the purchaser to which a CGT event could later happen, so as to produce a loss.

108. However, on closer examination of the provisions, paragraph 104-35(5)(b) simply provides that, if a right is created by one entity (first entity) in another entity which requires something to be done by the first entity that is another CGT event, CGT event D1 does not happen. It does not provide that the right should be ignored for CGT purposes.

109. The effect of paragraph 104-35(5)(b) is that section 104-35 does not apply to give rise to a taxing point for the creator, but section 109-5 still applies to a created right to bring about an acquisition of the right by the person in whom the right is created.

110. The main purpose of the amendments to subsection 160M(6) of the ITAA36, as set out in the explanatory memorandum to the Tax Laws Amendment Bill (No 4) 1992, is to clarify the operation of subsection 160M(6) with the effect that, if a person creates an incorporeal asset in another person, any consideration received by the creator for creating the asset is a capital gain.

111. The explanatory memorandum describes the purpose of subsection 160MA(2) of the ITAA36 as ensuring that subsection 160M(6) does not apply to deem a capital gain in respect of a created right if the right is a right to require a disposal of an asset (which itself would be subject to the CGT provisions). In effect, it avoids the potential for double taxation.

112. The application of the contractual rights approach to a defaulting purchaser does not result in the potential for double taxation. Accordingly, paragraph 104-35(5)(b) does not impede such an approach.

Contractual rights

113. Having dealt with the paragraph 104-35(5)(b) issues above, does the contractual rights approach apply to give a defaulting purchaser a capital loss?

CGT asset

114. It seems clear that the purchaser's bundle of contractual rights, e.g., the right to a transfer of the property, is an asset for CGT purposes. Being proprietary rights, they are an asset as defined both before and after 26 June 1992.

Acquisition

115. These rights are created by the vendor in the purchaser and are taken to have been acquired by the purchaser when the purchaser becomes the owner of the rights, that is, when the contract is entered into (subsection 109-5(1)).

Cost base

116. The cost base of these rights is the amount of the deposit, being money paid in respect of acquiring the rights, plus any incidental costs of acquisition and any incidental costs that relate to a CGT event happening to the rights.

CGT event

117. If the purchaser defaults, the vendor terminates the contract and the purchaser forfeits the deposit, there may be a surrender, forfeiture or abandonment of the rights such that there is an ending of the purchaser's ownership of the rights. If so, CGT event C2 happens (subsection 104-25(1)). Under subsection 104-25(2), the time of the CGT event is when the rights end, that is, at the time the contract is terminated.

118. CGT event C1 in section 104-20 (about a loss or destruction of a CGT asset) might also happen if a purchaser defaults, the vendor terminates the contract and the purchaser forfeits the deposit. A purchaser's contractual rights might be said to be lost or destroyed in these circumstances.

119. 'Destruction' seems to imply a positive or definite action on something, rather than a more passive giving up of something, and contemplates voluntary as well as involuntary actions.

120. On the other hand, 'loss' in the context in which it is used, does not contemplate voluntary actions. *The Macquarie Dictionary* defines 'loss' as 'the accidental or inadvertent losing of something dropped, misplaced or of unknown whereabouts; destruction or ruin'. Use of the words 'accidental' and 'inadvertent' certainly tend to imply an involuntary rather than a voluntary act.

121. If both CGT event C1 and CGT event C2 can apply if a purchaser forfeits a deposit, subsection 102-25(1) provides that the CGT event that is the most specific to the situation is the one to use. The circumstances surrounding the purchaser's default in each case determines which is the more specific CGT event.

122. If the circumstances are of a voluntary nature, there is as a result a surrender, abandonment or forfeiture by the purchaser of their contractual rights and CGT event C2 is the more specific CGT event.

(Even if there might also be a destruction of the purchaser's contractual rights the surrender, abandonment or forfeiture is more specific). For example, if a purchaser defaults simply by changing their mind, deciding to invest elsewhere or the like, CGT event C2 is the more specific CGT event.

123. If the circumstances are of a genuinely involuntary nature, there is a loss or destruction of the contractual rights and CGT event C1 is the more specific CGT event. For example, if a purchaser defaults because their finance fails, or because of extenuating personal circumstances, e.g., death of spouse, severe illness, natural disaster, CGT event C1 is the more specific CGT event.

Capital proceeds

124. Usually, no capital proceeds are received by a defaulting purchaser on the ending of their contractual rights. If an entity receives no capital proceeds from a CGT event, generally the entity is taken to have received the market value of the CGT asset that is the subject of the event (subsection 116-30(1)).

125. The market value of the right to a transfer of the real estate is the value of the real estate less the amount still to be paid. Assuming no movement in the value of the real estate between the date of contract and the date of forfeiture, this market value is the amount of the deposit already paid. For example, if a deposit of $10,000 is paid on entering into a contract for the sale of land for $100,000, the value of the right to require a transfer of the land comprises the value of the land, i.e., $100,000, less the liability to pay the unpaid balance of the purchase price, i.e., $90,000. The market value of the right is, therefore, $10,000.

126. With the market value of the right being equal to the amount of the deposit paid, and the cost base being the amount of the deposit paid plus incidental costs, a capital loss only to the extent of the incidental costs would arise. Refer to **Example 14** in this Ruling.

127. If the market value of the real estate has decreased to or below the amount of the unpaid purchase price between the date of the contract and the date of forfeiture, a purchaser is able to claim a capital loss for the full amount of the deposit forfeited. Refer to **Example 15** in this Ruling. This may occur in the case of a deferred settlement (where the price drops) or if a rapid downturn occurs in the market. Most cases we have examined have, in fact, fallen into these categories, as a marked drop in the market value of the real estate is often the reason behind a purchaser defaulting.

128. The general rule for substituting market value if no capital proceeds have been received, does not apply to CGT event C2 if it is the expiry of a CGT asset (subparagraph 116-30(3)(a)(i)). The market

value substitution rule in subsection 116-30(1) also does not apply if there is a loss or destruction of a CGT asset (CGT event C1) - section 116-25.

129. Do the contractual rights of a purchaser expire on termination of the contract? The short answer is no.

130. The term 'expiry' is limited to a situation in which an asset ends because of the effluxion of time, for example, when a period to exercise an option expires. When an option expires, it has no value irrespective of actions taken on behalf of the option holder. Substituting a market value at the time of the asset ending, as if the option had not expired, would give an inappropriate result. *The Macquarie Dictionary* definitions of 'expiry' and 'expire' support an effluxion of time construction, viz; 'a coming to an end; close; to die out, as a fire; to emit the last breath'.

131. There has not been an 'expiry' of the purchaser's contractual rights on termination of the contract and, therefore, the market value substitution rule in subsection 116-30(1) applies if CGT event C2 is the most specific CGT event.

132. If the market value of the real estate at the time of termination of the contract has dropped to or below the balance payable on completion of the contract, the market value of the contractual rights is nil and a bona fide purchaser is entitled to a capital loss of the amount of the deposit forfeited plus incidental costs.

133. If CGT event C1 is the most specific CGT event, the market value substitution rule does not apply and a bona fide purchaser is entitled to a capital loss of the amount of the deposit forfeited plus incidental costs regardless of the market value of the contractual rights or the underlying real estate.

Examples

Example 1 (main residence disposed of within a 'continuum of events')

134. Alison acquired her main residence after 19 September 1985. In June 1992 she entered into a contract for the sale of the residence for $400,000. A deposit of $20,000 was paid under the contract. In October 1992 the purchaser defaulted and Alison terminated the contract and the deposit was forfeited to her. The residence was immediately remarketed and in November 1992 it was resold for $320,000.

135. As the forfeited deposit was received as part of the 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit forms part of the capital proceeds from the disposal

of that asset and is eligible, therefore, for the main residence exemption.

Example 2 (pre-CGT asset disposed of within a 'continuum of events')

136. Lachlan purchased real estate for primary production purposes before 20 September 1985. After retiring, he entered into a contract to sell the real estate in June 1996 for $570,000. The sale was not completed and the deposit of $57,000 was forfeited to Lachlan in November 1996. The real estate was immediately remarketed and resold under a contract dated December 1996 for $505,000.

137. As the forfeited deposit was received as part of the 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit forms part of the capital proceeds from the disposal of that asset. As the real estate was acquired before 20 September 1985, the forfeited deposit is not subject to CGT.

Example 3 (disposal of a post-CGT asset within a 'continuum of events')

138. Olivia purchased a vacant block of land in August 1988. In April 1989 she entered into a contract to sell the land for $460,000. A deposit of $46,000 was paid under the contract, settlement being due in April 1990. The purchaser later defaulted and in May 1990 Olivia terminated the contract and the deposit was forfeited to her. In June 1990 the land was resold for $320,000.

139. As the forfeited deposit was received as part of a 'continuum of events' constituting the later disposal of the underlying asset, the forfeited deposit forms part of the capital proceeds from the disposal of the land under subsection 116-20(1). As the land was acquired after 19 September 1985, the forfeited deposit is, in effect, assessable as it adds to a capital gain or reduces a capital loss made on the disposal of the land.

140. Total capital proceeds from the disposal of the land is $366,000.

Example 4 (main residence, no disposal)

141. Susan acquired her main residence in 1980. In May 1994 she contracted to sell the residence for $360,000 and a deposit of $36,000 was paid under the contract. The purchaser did not complete the contract and so forfeited the deposit to Susan on 31 August 1994. Susan attempted to resell the residence by relisting it with a real estate agent for 6 months. However, this was unsuccessful. The residence

was then withdrawn from the market and remains unsold. As there has been no disposal of the underlying asset, the main residence exemption in section 118-110 cannot apply.

142. In this case, the vendor's bundle of contractual rights, and not the underlying asset, is the most relevant asset. There was an acquisition and an ending of ownership of the contractual rights by the vendor with the result that the forfeited deposit (less incidental costs) constitutes a capital gain in the 1994-95 year.

Example 5 (example of what constitutes a 'continuum of events')

143. Daniel acquired a large tract of vacant land in 1968. In February 1991 he entered into a contract of sale for the land with a developer for $14m under which a deposit of $350,000 was paid. The contract was not completed by the purchaser and the deposit was forfeited in February 1992.

144. In March 1992, Daniel corresponded with the property investment manager of a large institution to offer the land for sale. In April 1992 he also corresponded with a commercial property developer who arranged site inspections and for the introduction of potential Japanese buyers. Between May 1992 and March 1993, the land was listed with another real estate agent and was inspected by a number of interested parties from overseas. In the period between March and May 1993 the land was prepared for auction. It did not sell at auction. However, after further continued attempts to attract a buyer, the land was sold in September 1993.

145. In these circumstances, there have been continuous and reasonable attempts to resell the land after the original contract fell through. The forfeited deposit has been received within a 'continuum of events' constituting the later disposal of the land and, therefore, the forfeited deposit forms part of the capital proceeds from the disposal of the underlying asset. As the land was acquired before 20 September 1985, the forfeited deposit is not subject to CGT.

Example 6 (broken 'continuum of events')

146. Jordan acquired a rental property in 1980. In March 1991 he entered into a contract to sell the property for $2.1m. A deposit of $210,000 was paid under the contract, with settlement due in March 1993. However, the purchaser defaulted and the deposit was forfeited to Jordan in April 1993. The property was then withdrawn from sale and not placed back on the market until March 1995. In July 1995 the property was resold.

147. As the 'continuum of events' was broken, the forfeited deposit can not be taken to be part of the capital proceeds from the disposal of

the underlying (exempt) asset. Rather, the vendor makes a capital gain in the 1992-93 year as there has been an acquisition and an ending of ownership of the vendor's contractual rights, the contractual rights being the most relevant asset.

Example 7 (variation of Example 4, no disposal within 2 years, amendment required)

148. Assume the same facts as in **Example 4** except that Susan continued attempts to resell the residence. Despite her attempts, Susan had still not resold the residence by 31 August 1996 and this time lapse itself would be indicative of a break in the 'continuum of events'. At this point, there is substantial doubt whether a 'continuum of events' continues unbroken. So, Susan is well advised to amend her 1994-95 income tax return to include the forfeited deposit as a capital gain on the basis that there has been an ending of her ownership of her contractual rights on 31 August 1994, the contractual rights being the most relevant asset. Susan later withdraws the residence from the market.

149. If Susan had discontinued her attempts to resell the residence in, say, August 1995, she would be required to amend her 1994-95 return (or include the forfeited deposit in that return if it had not been lodged) then and not wait any longer (e.g., until the 2 year period has expired).

Example 8 (land subdivision, 'continuum of events')

150. Len acquired his farming land in 1948 and farmed the land until his retirement in 1993. He offered the land for sale and later entered into a contract for sale with the owner of a neighbouring farm. A deposit of $50,000 was paid under the contract.

151. The neighbour did not complete the contract and the deposit was forfeited to Len. Len put the farm straight back on the market. However, Len's real estate agent advised that, in view of the drought and increasing uncertainty with export markets, it would be difficult to sell the farm as a going concern and that subdividing the land may be the only means of disposing of it.

152. Accordingly, Len subdivided the land, marketed it and sold the subdivided blocks.

153. Len has shown a continuous commitment to resell the land after the original contract fell through. He has taken reasonable advice in the circumstances to subdivide the land as a means of disposing of it. At all times he pursued his intention to dispose of the land.

154. In these circumstances, the subdivision of the land did not break the 'continuum of events'. The forfeited deposit was received within a 'continuum of events' constituting the later disposal of the land. The forfeited deposit forms part of the capital proceeds from the disposal of the underlying asset. As the land was acquired before 20 September 1985, the forfeited deposit is not subject to CGT.

Example 9 (renovation before resale, 'continuum of events')

155. Giovanni acquired a residential property for rental purposes in 1980. He leased the property to various tenants over the years before deciding to dispose of the property in 1993. He entered into a contract for sale in November 1993 under which a deposit of $10,000 was paid. The purchaser did not complete the contract and the deposit was forfeited in April 1994.

156. Giovanni became aware that unauthorised alterations had been made to the property by the tenant and that restoration work was needed. It remained his intention to dispose of the property as soon as possible. He proceeded to carry out the required work before relisting the property for sale. Shortly after the work was completed the property was resold in October 1994.

157. In these circumstances, the carrying out of the renovations did not break the 'continuum of events'. The forfeited deposit was received within a 'continuum of events' constituting the later disposal of the underlying asset. The forfeited deposit forms part of the capital proceeds from the disposal of the underlying asset. As the rental property was acquired before 20 September 1985, the forfeited deposit is not subject to CGT.

Example 10 (rollover relief, 'continuum of events')

158. Johannes acquired a residential property for rental purposes in 1986. In March 1995 he entered into a contract to sell the property. The purchaser did not complete the contract and the deposit was forfeited to Johannes in June 1995. Johannes immediately attempted to resell the property. However, before he could do so, the property was transferred to his spouse because of a Family Court order.

159. In these circumstances, the rollover relief available under section 126-5 effectively exempts the forfeited deposit from CGT.

Example 11 (rollover relief, break in 'continuum of events')

160. Lana acquired industrial premises in 1976 to conduct her steel fabrication business. In March 1996 she entered into a contract to sell

the premises. The purchaser did not complete and the contract was terminated and deposit forfeited to Lana in June 1996.

161. Lana relisted the premises and continued attempts to resell them. While she was doing so, she decided to transfer the premises to a wholly owned company.

162. Such a transfer is not consistent with a continuing intention to resell the asset and, therefore, breaks the 'continuum of events'. In this situation, the vendor's bundle of contractual rights is the most relevant asset. There was an acquisition and an ending of ownership of these rights by the vendor, with the result that the forfeited deposit (less incidental costs) constitutes a capital gain in the 1995-96 year.

Example 12 (forfeited instalment, disposal within a 'continuum of events')

163. Helen acquired a commercial property in 1974. In May 1989 she entered into a contract to sell the property for $2m. A deposit of $200,000 was paid under the contract. An instalment of the purchase price of $500,000 was also paid in August 1989, in accordance with the contract, with settlement due in August 1992. The purchaser later defaulted and the deposit was forfeited in June 1992.

164. Legal action was commenced against the purchaser and settled in November 1992, on the basis that the vendor was entitled to retain the instalment already paid under the contract. The property was resold soon after in December 1992.

165. In these circumstances, the forfeited instalment and the forfeited deposit were received as part of a 'continuum of events' constituting the later disposal of the underlying asset. The forfeited instalment forms part of the capital proceeds from the disposal of the underlying asset. As the property was acquired before 20 September 1985 the forfeited instalment is not subject to CGT.

Example 13 (forfeited instalment, no 'continuum of events')

166. Ben acquired 42 ha of vacant land in 1965 for grazing purposes. In March 1990 he entered into a contract to sell the land for $6.2m. A deposit of $600,000 was paid at the time of the contract. An instalment of $2.6m was also paid in March 1991 in accordance with the contract. Settlement was due in March 1992. The purchaser defaulted, after which the contract was terminated and the deposit forfeited in April 1992.

167. The land remained on the market and in November 1992 was offered for sale at auction. However, no sale eventuated.

168. Legal action was commenced by both parties and was settled in February 1993 by both parties entering into an agreement resulting in the vendor not being entitled to anything further by way of damages and the purchaser not being entitled to a return of any part of the amounts previously paid.

169. After the auction in November 1992, the land was withdrawn from sale and not placed back on the market until March 1996. In June 1996 the land was resold. As the 'continuum of events' was broken the forfeited deposit is assessable in accordance with **Example 6**.

170. With respect to the forfeited instalment, the most relevant asset is Ben's right to seek compensation. This right was acquired at the time of the purchaser's breach and ended at the time the legal action was settled, i.e., February 1993. The forfeited instalment represents capital proceeds from the ending of Ben's ownership of the right.

Example 14 (defaulting purchaser, no capital loss)

171. Assume the same facts as **Example 6**. Megan, the purchaser, after deciding of her own volition not to proceed, defaulted and forfeited the deposit of $210,000 to the vendor in April 1993. At this time, the market value of the property was still $2.1m, being the market value sale price specified in the original contract.

172. The market value of the property at the time of termination of the contract had not decreased. The market value of the purchaser's contractual rights (and, hence, the capital proceeds from the CGT event that happens to those rights) remains the amount of the deposit already paid - $210,000, that is, the value of the land less the amount still to be paid. As the cost base is also $210,000 plus incidental costs, the purchaser is entitled to a capital loss only to the extent of the incidental costs.

Example 15 (defaulting purchaser, capital loss)

173. Assume the same facts as **Example 14** except that when the contract was terminated and the deposit forfeited in April 1993, the market value of the property was $1.5m, having decreased from the $2.1m specified in the contract.

174. As the market value of the property at the time of termination of the contract had dropped below the balance payable on completion, the market value of the purchaser's contractual rights is nil and the purchaser is entitled to a capital loss of the amount of the deposit forfeited (plus incidental costs).

Detailed contents list

175. Below is a detailed contents list for this Ruling:

Last Ruling

This is the last Taxation Ruling for the 1999 calendar year. The next Ruling will be Taxation Ruling TR 2000/1.

Commissioner of Taxation
15 December 1999

Previous draft:

Previously issued as TR 1999/D4

Related Rulings/Determinations:

TR 94/29; TR 95/35

Subject references:

- acquisition
- capital gain
- capital gains tax
- CGT asset
- CGT event
- capital loss
- capital proceeds
- compensation
- contract
- contractual rights
- continuum of events
- cost base
- damages
- forfeited deposit
- main residence
- market value
- rights
- right to seek compensation
- rollover

Legislative references:

- ITAA97 6-5
- ITAA97 8-1
- ITAA97 102-25(1)
- ITAA97 102-25(3)(b)
- ITAA97 104-10
- ITAA97 104-10(2)
- ITAA97 104-20
- ITAA97 104-25
- ITAA97 104-25(1)
- ITAA97 104-25(1)(c)
- ITAA97 104-25(2)
- ITAA97 104-35
- ITAA97 104-35(5)(b)
- ITAA97 104-150
- ITAA97 104-150(2)
- ITAA97 104-150(3)
- ITAA97 104-155
- ITAA97 108-5(1)
- ITAA97 109-5
- ITAA97 109-5(1)
- ITAA97 109-5(2)
- ITAA97 110
- ITAA97 110-25(2)
- ITAA97 110-25(2)(b)
- ITAA97 110-25(3)
- ITAA97 110-25(3)(a)
- ITAA97 110-25(3)(b)
- ITAA97 110-35
- ITAA97 112-20
- ITAA97 112-20(1)
- ITAA97 112-20(3)
  ITAA97 116-20(1)
- ITAA97 116-20(1)(a)
- ITAA97 116-25
- ITAA97 116-30(1)
- ITAA97 116-30(1)
- ITAA97 116-30(3A)
- ITAA97 118-110
- ITAA97 118-110(2)(b)
- ITAA97 122-A
- ITAA97 126-A
- ITAA97 126-5
- ITAA97 126-B

- ITAA97 128
- ITAA36 25(1)
- ITAA36 51(1)
- ITAA36 160A
- ITAA36 160A(a)
- ITAA36 160M(1)
- ITAA36 160M(3)(b)
- ITAA36 160M(5)(c)
- ITAA36 160M(6)
- ITAA36 160M(6A)
- ITAA36 160M(6B)
- ITAA36 160M(6B)(b)
- ITAA36 160M(7)
- ITAA36 160MA(2)
- ITAA36 160U(3)
- ITAA36 160U(4)
- ITAA36 160U(6)(a)(i)
- ITAA36 160U(6)(b)(i)
- ITAA36 160X
- ITAA36 160ZD(1)
- ITAA36 160ZD(1)(a)
- ITAA36 160ZD(2)(a)
- ITAA36 160ZD(2B)(a)
- ITAA36 160ZD(3)
- ITAA36 160ZH
- ITAA36 160ZH(1)
- ITAA36 160ZH(1)(a)
- ITAA36 160ZH(1)(b)
- ITAA36 160ZH(1)(e)
- ITAA36 160ZH(2)
- ITAA36 160ZH(2)(a)
- ITAA36 160ZH(2)(b)
- ITAA36 160ZH(2)(e)
- ITAA36 160ZH(4)
- ITAA36 160ZH(5)
- ITAA36 160ZH(7)
- ITAA36 160ZH(9)
- ITAA36 160ZH(9)(a)
- ITAA36 160ZZC
- ITAA36 160ZZC(3)(a)
- ITAA36 160ZZC(12)
- ITAA36 160ZZC(12)(a)
- ITAA36 160ZZM
- ITAA36 160ZZN
- ITAA36 160ZZO
- ITAA36 160ZZQ
- ITAA36 160ZZQ(12)
- ITAA36 170(3)
- ITAA36 170AA
- ITAA36 170AA(11)
- -Taxation Laws Amendment Act (No 4) 1992
- Conveyancing Act 1919 (NSW) 12

Case references:

- Brien v. Dwyer and Another (1978) 141 CLR 378
- FC of T v. Guy 96 ATC 4520; (1996) 32 ATR 590
- FC of T v. Guy 96 ATC 4531; (1996) 32 ATR 601
- FC of T v. Orica Limited (formerly ICI Australia Limited) 98 ATC 4494; (1998) 39 ATR 66
- FC of T v. Tully Co-operative Sugar Milling Association Limited 83 ATC 4495; (1983) 14 ATR 495
- Howe v. Smith [1884] 27 Ch D 89
- Lysaght v. Edwards [1876] 2 Ch D 499
- National Trustees Executors and Agency Company of Australasia Limited v. FC of T (1954) 91 CLR 540
- State Government Insurance Office v. Rees and Another (1979) 144 CLR 549; 26 ALR 341
- The Queen v. Toohey & Anor: ex parte Meneling Station Pty Ltd & Ors (1982) 158 CLR 327
- Workers Trust and Merchant Bank Ltd v. Dojap Investments Ltd [1993] AC 573
- Zim Properties Ltd v. Proctor (HM Inspector of Taxes) (1984) 58 TC 371
- Case 32/94 94 ATC 298; AAT Case 9538 (1994) 28 ATR 1230

ATO references:
NO 98/7424-1; 99/4532-6; 99/18003-0

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Addendum

Income tax: capital gains: treatment of forfeited deposits

1. Taxation Ruling 1999/19 has been affected by the decision of the Full Court of the Federal Court of Australia in *Brooks v FC of T* [2000] FCA 721; 2000 ATC 4362; (2000) 44 ATR 352 on 9 June 2000 and should be applied in the light of that decision.

2. The Commissioner, faced with the Full Federal Court decision in *FC of T v Guy* 96 ATC 4520; (1996) 32 ATR 590, took the view in this Ruling that a contract for the sale of real estate was not a 'prospective purchase or other transaction' in terms of subsection 160ZZC(12) of *the Income Tax Assessment Act 1936* (ITAA 1936). The effect of this was that the Ruling expressed the opinion (paragraph 7) that neither subsection 160ZZC(12) of ITAA 1936 nor section 104-150 of the *Income Tax Assessment Act 1997* (ITAA 1997) applied to a deposit forfeited under an actual contract for the sale of real estate. The Ruling went on, however, to say that other capital gains provisions (in particular CGT event A1 in section 104-10 of ITAA 1997 or CGT event C2 in section 104-25 of ITAA 1997) applied to these forfeited deposits on the sale of post-CGT real estate (other than a main residence) so that they are assessable as a capital gain in the circumstances stated in paragraphs 9 and 11 of the Ruling.

3. The Federal Court in the *Brooks* case has now decided that the decision in the *Guy* case was – in the words of the Court - 'plainly wrong' and 'should not be followed'. The Court in the *Brooks* case had no difficulty in applying subsection 160ZZC(12) of ITAA 1936 to a deposit forfeited under an ordinary contract for the sale of real estate. As the Court said:

> 'Although, in the view we take, all of ss 160M(6), (7) and s 160ZZC(12) have application, because both ss 160M(6) and (7) are subject to the other provisions of Part IIIA, the consequence is that the provisions of s 160ZZC(12) will apply to bring into operation s 160ZZC(3).'

4. Accordingly, the main effect of the decision in the *Brooks* case on TR 1999/19 is that it clarifies that if the forfeiture of a deposit under a contract for the sale of real estate does not occur within a 'continuum of events' as that expression is used in TR 1999/19, the forfeited deposit is assessable under CGT event H1 in section 104-150 of ITAA 1997 (or subsection 160ZZC(12) of ITAA 1936 if the forfeiture occurred before the beginning of the 1998-99 income year).

This is the case whether the contract is for the sale of pre-CGT real estate, post-CGT real estate or a main residence. The deposit (to the extent that it is more than any expenditure the vendor incurs in connection with the sale) is assessable as a capital gain in accordance with subsection 104-150(3) of ITAA 1997. This alters the position taken in TR 1999/19 (paragraphs 7, 12, 15 and 25) that the forfeited deposit in this situation was assessable as a result of CGT event C2 in section 104-25 of ITAA 1997 happening to the vendor's contractual rights and not under CGT event H1 in 104-150 of ITAA 1997.

5. If a deposit is forfeited under a contract for the sale of a main residence or pre-CGT real estate where the forfeiture occurs within a continuum of events constituting a later disposal of the main residence or pre-CGT real estate, the position taken in TR 1999/19 (paragraphs 9, 10 and 25) remains that the deposit is not assessable. In the ITAA 1997, this principle has, in the context of the main residence exemption, been given express statutory recognition in paragraphs 118-110(2)(b) and 118-195(2)(b). It also continues to apply (although by reference to general principles) for pre-CGT real estate.

6. If a deposit is forfeited under a contract for the sale of post-CGT real estate where the forfeiture occurs within a continuum of events constituting a later disposal of the post-CGT real estate, the position taken in TR 1999/19 (paragraphs 9, 11 and 25) remains that the deposit forms part of the capital proceeds from CGT event A1 in section 104-10 of ITAA 1997 happening to the post-CGT real estate. Paragraph 47 of the judgment in the *Brooks* case supports, by way of obiter dicta, this position: 2000 ATC at 4373; 44 ATR at 364.

7. Apart from these aspects, no other change to TR 1999/19 is necessitated by the decision in the *Brooks* case.

8. In this addendum 'pre-CGT real estate' means real estate acquired before 20 September 1985 and 'post-CGT real estate' means real estate acquired on or after 20 September 1985.

Note 1:

9. This addendum is incorporated into, and is to be read as one with, TR 1999/19. This addendum is a 'public ruling' for the purposes of Part IVAAA of the *Taxation Administration Act 1953* and is legally binding on the Commissioner. 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.

Note 2:

10. This addendum applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before its date of issue (see paragraphs 21 and 22 of Taxation Ruling TR 92/20). Also, if a taxpayer has obtained a more favourable private ruling (whether legally or administratively binding) this addendum applies to that taxpayer to the extent of the inconsistency only from its date of issue.

11. In the unlikely event that the application of TR 1999/19 without this addendum would result in a smaller tax liability for a taxpayer than its application incorporating this addendum, the taxpayer is entitled to apply Taxation Ruling TR 1999/19 without this addendum for deposits forfeited on or before the issue date of this addendum.

Commissioner of Taxation
11 October 2000

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