TR 94/32 - Income tax: non-accrual loans

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Taxation Ruling
Income tax: non-accrual loans

other Rulings on this topic

TR 92/18; TR 93/27

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling:

- discusses whether interest accruing under a loan contract should be brought to account under subsection 25(1) of the *Income Tax Assessment Act 1936* (the Act) after the loan is classified by the lender as a non-accrual loan;
- provides criteria for establishing when a loan should be classified as non-accrual for income tax purposes; and
- discusses the deductibility of bad debts in respect of interest not previously brought to account as assessable income.

2. The Ruling applies to all taxpayers who come within the definition of a 'financial institution' set out in paragraphs 21-23 of Taxation Ruling TR 93/27.

3. The Ruling does not apply to discount income or to income (other than periodic interest) from qualifying securities to which Division 16E of Part III of the Act applies.

Ruling

4. In TR 93/27 we accept that interest income is derived by a financial institution for income tax purposes on a daily accruals basis unless the loan agreement specifically states that the interest does not accrue day by day.

5. When a financial institution makes a bona fide assessment based on sound commercial considerations that there is little or no likelihood that the accrued interest will be received, we accept that for income tax purposes the loan can be classified as a 'non-accrual loan'. Any interest accruing thereafter will not be derived for income tax purposes

until it is actually received. The types of things which we consider will indicate that a bona fide assessment had been made are set out at paragraph 47 of this Ruling.

6. If the financial circumstances of the borrower improve so that the loan should no longer be treated as non-accrual for income tax purposes, then all interest accrued and not returned as assessable income should be returned as income derived. Interest accruing thereafter should be returned as income in accordance with TR 93/27.

7. Interest accrued but not received at the time of classifying a loan as non-accrual should be returned as assessable income. However, where the debt in respect of that interest is considered to be bad, a bad debt deduction may be available in respect of that amount.

8. Where, in accordance with this Ruling, interest has not been returned as assessable income and subsequently the debt owing in respect of the loan is written off, released or otherwise realised, no deduction in respect of that part of the debt which represents the interest not returned as income is available under either subsection 51(1) or paragraph 63(1)(b) of the Act.

Date of effect

9. Subject to what is said in paragraph 10 below, 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 a 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).

10. We have, in the past, accepted returns from finance companies that carried interest to a suspense account when the ultimate amount of interest uncollected was 95% or more of the amount carried to that account. This approach is inconsistent with what we understand the law requires as set out in this Ruling. Finance companies should therefore lodge returns in respect of years of income commencing on or after 1 July 1994 in accordance with the views set out in this Ruling.

Explanations

11. For financial reporting and credit control purposes, financial institutions continually review credit risk associated with outstanding loans. When those reviews reveal a level of risk such that there is doubt about the ultimate receipt of the future cash flows due under the

loan, the loan is likely to be classified by the lender as a non-accrual loan. Interest on non-accrual loans is not taken to profit on an accruals basis but, rather, only when it is received.

12. For income tax purposes interest earned by a lender is considered to have the character of income and is included in the assessable income of the lender in the period during which it is derived. We have been asked whether a non-accrual loan can be considered to be sufficiently impaired or non-performing such that there is no interest accruing in respect of that loan that is income derived by the lender in the relevant period.

What is a non-accrual loan?

13. The Reserve Bank of Australia (RBA) issued guidelines in December 1993 for classifying and reporting the problem loans and other impaired assets of banks under its supervision. The guidelines, entitled *Recognition and Measurement of Impaired Assets* are intended to achieve a consistent treatment of banks' problem loans and require banks to report on loans which fall into the following categories:

non-accrual items;

restructured items; and

other assets acquired through the enforcement of security conditions.

14. For the purposes of those guidelines non-accrual items are those facilities on which income may no longer be accrued ahead of receipt and are defined as:

'(i) facilities where there is reasonable doubt about the ultimate collectability of principal and interest within a time frame established by the bank, but in any case not significantly longer than the term of the original facility. Non-accruals would include all facilities against which a specific provision has been established or a write off taken (except in the case of restructured facilities and assets acquired through security enforcement) even if the facility is not in breach of contractual requirements;

(ii) facilities not included in (i) where contractual payments of principal and/or interest are 90 or more consecutive days in arrears, and where the 'fair value' of security is insufficient to cover payment of principal and accrued interest. In line with the principles outlined above, a facility should be classified as non-accruing earlier than 90 days where it is evident that full or partial recovery of the debt, including

interest, is unlikely even though the full extent of the loss cannot be clearly determined;

(iii) overdrafts not included in (i) which have remained continuously outside approved limits (including unadvised internally authorised excesses or extensions approved as part of the initial credit process) for 90 or more consecutive days and where security is insufficient to cover the bank's exposure (including accrued interest); and

(iv) facilities on which the customer is making contractual payments, but which are maintained on a cash basis because of a significant deterioration in the financial performance or financial position of the borrower.'

15. The accounting treatment of non-accrual loans is not the subject of a specific accounting standard. However, the *Statement of Accounting Concepts SAC 4: Definition and Recognition of the Elements of Financial Statements*, provides at paragraph 109:

> 'A revenue shall be recognised in the operating statement, in the determination of the result for the reporting period, when and only when:
>
> (a) it is probable that the inflow or other enhancement or saving in outflows of service potential or future economic benefits has occurred; and
>
> (b) the inflow or other enhancement or saving in outflows of service potential or future economic benefits can be measured reliably.'

16. The financial accounting treatment of non-accrual loans is addressed in a discussion paper entitled *Banking and Finance Industry Discussion Paper: Disclosure in Financial Statements of Impaired Assets and Related Issues*. The paper was issued in June 1994 by the accounting firms Coopers & Lybrand, Ernst & Young, KPMG Peat Marwick and Price Waterhouse. The purpose of the paper is to 'outline a methodology for classifying and disclosing, in published financial statements, loans and similar financial exposures where there is a degree of doubt about collectability' (see paragraph 1.1). The principles of the paper 'are relevant to all financial institutions' (paragraph 1.2); and the paper 'may represent "interim guidance" until the Australian Accounting Research Foundation (AARF) develops a Statement of Accounting Standards on disclosures by financial institutions.' The discussion paper does not have the authority of an accounting standard. However, it evidences the generally accepted accounting principles which apply to the treatment of non-accrual loans. The paper describes a non-accrual loan as:

'a loan or similar facility where there is reasonable doubt about the ultimate collectability of any of the interest (overdue and future) and/or principal outstanding and, as a consequence, the accrual of interest in the profit and loss account in relation to this facility has been suspended.'

17. The discussion paper also provides (at pp 4-5) the following criteria for identifying non-accrual loans:

'
- a significant deterioration of the customer's financial performance has occurred or is anticipated;
- the underlying business of the customer is not generating cash flows sufficient to meet payments as and when they fall due;
- there is reasonable doubt whether the realisable value of the security or expected cash flow covers the full amount of the outstanding balance and/or future interest yet to be accrued, and the bank is relying on security or expected cash flows to recover the outstanding balance;
- the facility is not complying with important contractual terms, e.g., facilities are past due 90 days;
- a specific provision has been established or a write off taken.'

18. Taking the relevant reporting and accounting guidelines together it can be seen that financial institutions are being asked to be conservative in recognising a facility as a non-accrual item. In some cases classification will occur when the collectability of any principal and/or interest becomes doubtful even though there may not, as yet, have been a breach of the contractual terms of the facility.

Income tax considerations

19. Section 17 of the Act provides that income tax is levied upon the taxable income derived during the year of income by any person.

20. In *Commercial and General Acceptance Limited v. F C of T* (1976-77) 137 CLR 373, Mason J said (at 381):

'The Income Tax Assessment Act 1936 provides for a method of arriving at a taxpayer's taxable income which is artificial in that it is based on the taxpayer's assessable income from which are subtracted deductions allowed by the Act (s. 48). The expression "assessable income" is defined by s. 6 so as to mean "all the amounts which under the provisions of this Act are included in the assessable income". The Act contains a series of specific provisions including a variety of amounts in the

assessable income of a taxpayer. Of these specific provisions s. 25(1) is the most important; it includes in the assessable income the gross income of the taxpayer.'

21. The gross income to which subsection 25(1) is directed is, more specifically, the gross income 'derived' by that person during the relevant period.

22. In *Brent v. F C of T* (1971) 125 CLR 418, Gibbs J said (at 427):

> 'The Act does not define the word "derived" and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer, although particular situations not relevant to the present case are dealt with.
> The word "derived" is not necessarily equivalent in meaning to "earned". "Derive" in its ordinary sense, according to the Oxford English Dictionary, means "to draw, fetch, get, gain, obtain (a thing from a source)". It has become well established that unless the Act makes some specific provision on the point the amount of income derived is to be determined by the application of ordinary business and commercial principles and that the method of accounting to be adopted is that which "is calculated to give a substantially correct reflex of the taxpayer's true income" (*The Commissioner of Taxes (South Australia) v. The Executor, Trustee and Agency Company of South Australia Limited (Carden's case)* (1938) 63 CLR 108 at pp 152-4).'

23. The method of accounting to be adopted will depend on the nature of the income-producing activities of the taxpayer. As a general proposition the choice is between the 'cash' or 'receipts' basis and the 'accruals' or 'earnings' basis. In *Carden's* case Dixon J said (at 151-152):

> 'The question whether one method of accounting or another should be employed in assessing taxable income derived from a given pursuit is one the decision of which falls within the province of courts of law possessing jurisdiction to hear appeals from assessments. It is, moreover, a question which must be decided according to legal principles.'

24. Later (at 156-157) he said:

> 'The distinction, if not opposition between the mode of accounting sometimes called the accrual system and that based upon actual receipts and disbursements is widely known.
> The foundation of the accrual system is the view that the accounts should show at once the liabilities incurred and the revenue earned independently of the date when payment is made or becomes due.'

25. In the same case (at 124) Latham CJ said:

> 'In the case of a trader it is well established that he must take into account book debts owed to him as part of his income, at least where those book debts fall due during the year in respect of which he is making his return. An allowance may be made under statutory provisions for bad and doubtful debts, but, subject to such an allowance, the book debts must be returned as part of a trader's income.'

26. In *J Rowe & Sons Pty Ltd v. F C of T* (1970-71) 124 CLR 421, the taxpayer was a retailer of household goods some of which were sold on instalment terms. A contention of the taxpayer was that for taxation purposes, it was incorrect to bring into the annual account as assessable income any instalments of the purchase price for goods sold upon terms which are neither received nor receivable in the course of the year of sale. To this contention Menzies J responded (at 448):

> 'Acceptance of the taxpayer's contention would, of course, largely destroy the accepted basis for the taxation of most trading and business concerns. It is accepted that, for taxation as well as for business purposes, the income of such a business is derived when it is earned and the receipt of what is earned is not necessary to bring the proceeds of sale into account. The acceptance of this basis of accounting is recognised by the provisions of the Act relating to the writing off of bad debts which "have been brought to account by the taxpayer as assessable income of any year": see s. 63.'

27. In the case of a financial institution it can readily be accepted that the accruals method is the more appropriate method of ascertaining the true income of the enterprise. This was accepted in *Commissioner of Inland Revenue v. The National Bank of New Zealand* 77 ATC 6001; (1977) 7 ATR 282, both by the Court and the parties to the litigation.

28. In TR 93/27 we discuss the correct basis of assessment of interest derived and incurred by financial institutions. Financial institutions generally adopt a straight line daily accruals method of accounting for interest income and interest expense. This reflects the common law rule that interest accrues day by day and is in accordance with generally accepted accounting practice in Australia. We have accepted that a straight-line daily accrual is the appropriate method for a financial institution to bring to account interest income for taxation purposes, rather than a due and receivable form of accruals, where the terms and conditions of the relevant contract indicate that the parties do not intend to disturb the ordinary rule that interest accrues on a daily basis over the period of a loan.

29. That Ruling does not, however, specifically address the case where there is doubt as to the ultimate collection of the interest accruing. The time at which interest receivable by a financial institution becomes income when there may be some doubt as to the collection of the interest was considered in the *Commissioner of Inland Revenue v. The National Bank of New Zealand* (supra). The decision of Haslam J at first instance in the Supreme Court of New Zealand and the subsequent decision of the Court of Appeal both place some reliance on Australian authorities.

30. In the *National Bank of New Zealand* case, the taxpayer's practice was to debit all debtor accounts with interest each half year. The interest was then, generally, carried to the profit and loss account. An exception occurred in respect of interest debited to accounts that were considered to be in doubt of ultimate realisation. Instead, these amounts were credited to a 'suspended interest account' and were only brought into the bank's profits if the account was reclassified or the interest was actually received. The question for decision was whether the amount credited to the suspended interest account during a year of income should form part of the bank's assessable income for that year.

31. Haslam J at first instance found in favour of the bank. However, the Court of Appeal, in reversing his judgment, found that Haslam J had erred in his factual findings as to the nature of the suspended interest accounts. Wild CJ (at ATC 6015; ATR 285) observed that the earlier decision was based on the 'acceptance that interest was unlikely to be received whereas the bank's view was merely that its ultimate realisation was in doubt'. Cooke J referred to a number of Australian High Court decisions and, after reviewing the judgment of Dixon J in *Carden's* case, found (at ATC 6029; ATR 302):

> 'There is no solid support in any of this for a suggestion that for tax purposes an enterprise in the business of lending money and using an accrual basis for the interest on business debts which it considers as either undoubtedly good or as needing closer or stricter control - which categories between them comprise the vast majority of the business debts - is entitled to put the very small proportion being doubtful interest into a suspense account.'

32. Further, Cooke J observed (at ATC 6030; ATR 303):

> 'Taken as a whole the Australian cases show that accountancy evidence may be important, and they emphasise that in every case the ideal is what Dixon J called "a substantially correct reflex" of the particular taxpayer's income; but they seem to me to provide no ground for thinking that the tax legislation allows a business enterprise, not operating generally on a cash basis, in computing its gross profits to ignore doubtful debts, even if

through the technique of a suspense account that approach may be made acceptable for general accounting purposes.'

33. Cooke J concluded by saying that the various legal authorities show that (at ATC 6033; ATR 307):

> '...the Act requires a true view or reflex of the taxpayer's annual income; and that when interest has been earned and charged by such a business, and assets consisting of current book debts of substantial value have thereby been gained, the annual income cannot be ascertained with reasonable accuracy without taking these debts into account.'

34. The assessability of income where the receipt of that income is in doubt has been considered on a number of other occasions by the courts. In *St Lucia Usines and Estates Company Ltd v. Colonial Treasurer of St Lucia* [1924] AC 508 Lord Wrenbury said (at 512):

> 'a commercial company in preparing its balance sheet and profit and loss account, does not confine itself to its actual receipts - does not prepare a mere cash account - but values its book debts and stock in trade and so on and calculates its profit accordingly. From the practice of commerce and of accountants and from the necessity of the case this is so. But this is far from establishing that income arises or accrues from (as above instanced) an investment which fails to pay the interest due.'

35. In *Permanent Trustee Co and Another (Executors of estate of Frederick Henry Prior, deceased) v. Federal Commissioner of Taxation* (1940) 6 ATD 5 the question of the assessability of doubtful interest was addressed. The deceased was a member of a partnership and had lent money both to the partnership and to the sole co-partner. Upon dissolution of the partnership as from the year ended 30 June 1932, the former co-partner executed a deed dated 13 August 1932 whereby he undertook personal liability for the amount of principal and interest owing to the deceased in respect of the partnership and personal loans. The liability was secured by a deed of mortgage over certain property that was already mortgaged. The debtor was, at the time of capitalisation of the interest, and after that time, unable to pay the amount owing. The taxpayer knew of the debtor's inability to pay the amount of interest. The Commissioner contended, relying on section 19 of the Act, that the interest was derived by the deceased in the 1932 income year but capitalised by means of the deed of dissolution. Under the deed the interest was carried to a capital account. In his judgment Rich J said (at 12-13):

> 'In the present case the interest was by the deed carried to capital account and in this sense capitalised. But, section 19 does not say that wherever this happens income shall be deemed to be

> derived but it says that it shall be deemed to be derived income on the assumption that it is income and in other respects is derived notwithstanding that there is no payment over but a capitalisation or other dealing on behalf of the taxpayer or under his direction. ...But here the facts show that the deceased got nothing except a new obligation to pay in exchange for an existing obligation to pay. He was no nearer getting his money or of transferring it into anything of any value. His debtor could neither pay nor secure payment of the debt to him except by charging it on property already heavily mortgaged and quite incapable of producing a surplus out of which the amount representing interest could be paid. To see whether income has been derived one must look at realities. Usually payment of interest by cheque involves a receipt of income but payment by a valueless cheque does not. "For income tax purposes receivability without receipt is nothing," Law of Income Tax (Sir Holdsworth Shaw and Baker) p 111. You do not transform interest into an accretion of capital by writing out words on a piece of paper. There must be some reality behind them. Some accretion of value to corpus. The facts in this case show that there was not "an actually realised or realisable profit": *Cross v. London and Provincial Trust Ltd*. All that happened in this case was to change a forlorn hope of interest into a still more forlorn hope of capital.'

36. In *Ballarat Brewing Company Limited v. Federal Commissioner of Taxation* (1951) 82 CLR 364 the taxpayer sold its products on the terms that the customer was entitled to a discount and a rebate if certain conditions were fulfilled. A discount was allowed for prompt payment for the liquor supplied and a rebate was allowed depending on the price the customer sold the liquor and certain other aspects of the conduct of the customer's business. The net sale price was received in almost every case. The taxpayer calculated its assessable income on the basis of sales net of rebates and discounts whereas the Commissioner contended that they were not to be brought into account until they had actually been 'allowed' by acceptance of the net price from the customer as payment in full for the liquor to which they related. In deciding in favour of the taxpayer Fullagar J said (at 368-369):

> 'The matter seems to me to be a matter of arriving at the correct figure for a primary item, in the relevant calculation, the correct figure to ascribe to "sales" for the relevant accounting period. The question does not depend on any express provision to be found in the Act. It depends upon "the conceptions of business and the principles and practices of commercial accountancy"

(per Dixon J. in *Commissioner of Taxes (SA) v. Executor Trustee & Agency Co. of South Australia Ltd* (Carden's case).

'... It is the appropriate figure for book debts that is in question. This is in essence a matter of estimation, and (apart from express provision in the Act) it would be proper to make an allowance for bad and doubtful debts. In *Sun Insurance Office v. Clark* (1912) AC 443 at p 454, Lord Loreburn said:- "There is no rule of law as to the proper way of making an estimate. There is no way of estimating which is right or wrong in itself. It is a question of fact and figures whether the way of making the estimate in any case is the best way for that case". And (to quote again from the judgement of Dixon J in *Carden's* case) "the admissibility of the method which in fact has been pursued must depend upon its actual appropriateness. In other words the enquiry should be whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income".

'What I have said provides, in my opinion, the only proper approach to the question in the present case. And, when the question is so approached, the answer seems to me to be plain. Which figure - the Commissioner's or the Company's - represents, or more nearly represents the truth and reality of the situation? The company's figure brings into account what the company will, in the light of all past experience and policy, almost certainly receive in respect of book debts - no more and no less. The Commissioner's figure brings into account sums which the company will certainly, or almost certainly, not receive in respect of book debts. A trading account and profit and loss account based on the latter figure would be misleading, and there is nothing in the Act which requires the assessment of income on the basis of accounts which would be misleading in this respect.'

37. It seems that Fullagar J accepted a methodology where bad and doubtful debts are taken into account in estimating book debts due at the end of an income year. We believe that this is at odds with both earlier cases (e.g., *Carden's* case) and later cases (e.g., *J Rowe & Sons*) decided by the High Court. Leaving aside bad debts for the moment, we understand the correct position to be that book debts of a trader or other business that are doubtful debts are to be brought to account as assessable income and any deduction (whether under subsection 51(1) or section 63) in respect of such debts that become bad debts is not available at least until the year in which they actually become bad (ignoring also the other requirements of section 63).

38. As a general proposition Australian courts have held that taxpayers who correctly return their income on an accruals basis derive that income when a recoverable debt is created. That is, the taxpayer is not obliged to take any further steps before becoming entitled to payment. So, for example, in ascertaining the earnings of a professional practice only fees that have matured into recoverable debts should be included as earnings: *Henderson v. F C of T* (1969-70) 119 CLR 612. A statutory impediment to commencing legal proceedings for recovery of a debt does not defer the time at which fee income is derived under subsection 25(1) by a professional whose income is assessable on an accruals basis: *Barratt v. FC of T* 92 ATC 4275; (1992) 23 ATR 339. In *FC of T v. Australian Gas Light Co & Anor* 83 ATC 4800; (1983-1984) 15 ATR 105, the taxpayer supplied gas to consumers within a statutory regime that set down various conditions precedent to the making of a demand for payment. Accordingly, the Full Federal Court held that no income had been derived in respect of gas supplied but unbilled because the statutory requirements necessary to be met in order to make a demand for payment had not been satisfied. There was, at the end of the relevant income period, no debt in existence in respect of the unbilled gas.

39. In *Henderson v. FC of T* (supra) Windeyer J said (at 637):

> '...services may create debts before a bill is sent to the debtor. But services rendered do not produce taxable income until they create a debt. **And it must be a debt which is in fact recoverable, not a bad debt**' (emphasis added).

40. We understand this to mean, in a practical sense, that income that would otherwise be derived in respect of a recoverable debt will not be so derived if, at the time when the debt arises the debt is one which would be considered bad for the purposes of the Act.

41. This is not dissimilar to the proposition expounded by Dixon J in *Carden's* case (supra) where he stated (at 155):

> 'Speaking generally, in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a realised or immediately realisable form.'

42. As indicated above, the *National Bank of New Zealand* case supports the view that interest that is merely doubtful is nonetheless derived when it is charged by the lender. But that is not to say that the relevant interest is income as it falls due if the ultimate collection of interest accruing under a loan contract is more than doubtful. Where the collectability is unlikely, in the sense embodied in Windeyer's J comments in *Henderson* (i.e., that the debt is a bad debt at the time it arises), we think there is sufficient authority to support the view that

derivation of income ceases from the time that the lender makes a bona fide assessment based on sound commercial considerations that there is little or no likelihood that the accruing interest will be received.

43. Paragraphs 26-33 of Taxation Ruling TR 92/18 discuss what constitutes a bad debt for the purposes of the Act. The same considerations will apply in determining when the point in time arises for income tax purposes when interest accruing on a loan will not be income unless and until it is received.

Conclusions

44. In view of the above discussion of the relevant law it can be seen that in some cases the RBA guidelines will require recognition that income may no longer be accrued ahead of receipt whereas the true position for income tax purposes is that income is still being derived in the required sense at that time. For example, interest accruing under facilities within category (i) of the RBA guidelines where there has been no breach of the contractual requirements could not be taken at that time as not being derived as income of the lender. Nor would interest accruing under facilities where there is merely reasonable doubt about the ultimate collectability of principal and interest in a period not significantly longer than the term of the original facility.

45. Under some facilities principal and interest occur as a single payment at maturity of the loan. The RBA guidelines will in some cases require classification of a facility of this kind as non-accrual prior to maturity. However, we do not think that there is a point in time prior to maturity of such a loan when it can be said that interest income is not being derived, unless there is a breach of a contractual requirement which results in all amounts becoming due and payable at that time. In cases where there has been no such breach, the interest should be brought to account as income over the period of the loan. If a breach has occurred and the amounts due are, in fact, not recoverable, we will accept the facility is a non-accrual loan from that time onwards. Interest accrued up to that time should be returned as income.

46. There may be cases where contractual payments are in arrears for a period of 90 or more consecutive days and that the facility would otherwise be classified as non-accrual for income tax purposes. If, however, in the lender's view the fair value of the security is sufficient to ensure that the lender will recover principal and interest due under the facility, we think that interest income is being derived in respect of that facility notwithstanding the contractual obligations of the borrower are not being met.

47. In practice there will be a number of indicators that support and evidence a bona fide assessment based on sound commercial considerations that accrued interest is not likely to be received. We would expect that a lender has taken some appropriate action or events have occurred that indicate that the loan is, for income tax purposes, a non-accrual loan. The kind of things that support such an assessment are:

(a) in cases where the taxpayer is required to report impaired assets to the RBA, the loan is classified by the lender as a non-accrual item for RBA reporting purposes;

(b) the loan has been classified as a non-accrual loan in the books of account of the lender;

(c) the amount of the debt due from the customer in respect of the principal and interest is not increased in the books of account to reflect interest accruing but not charged to profit (entries to a memorandum or similar account may, however, still be occurring). Alternatively, where the books of account record the amount of the accrued interest not charged to profit, the accounting procedure should reverse any such interest prior to writing off any of the debt as bad;

(d) at the time of classification as a non-accrual loan the market value of any security in respect of the loan is insufficient to cover the debt - including accrued interest; and

(e) in respect of the principal and/or outstanding interest payments some of the following events have occurred:

  (i) reminder notices have been issued;

  (ii) a reasonable period of time has elapsed since the original due date for payment of the debt; this will of necessity vary depending upon the amount of the debt outstanding and the taxpayers' credit arrangements (e.g., 90, 120 or 150 days overdue);

  (iii) a formal demand notice has been served;

  (iv) a summons has been issued and served;

  (v) judgment has been entered against the borrower in respect of the debt; or

  (vi) execution proceedings to enforce judgment have commenced.

Subsection 51(1) and paragraph 63(1)(b) of the Act

48. For the purposes of paragraph 63(1)(b) of the Act a debt in 'respect of money lent' includes capitalised interest: *F C of T v. Commercial Banking Corporation of Australia Ltd* 83 ATC 4715; (1983) 15 ATR 21. See also paragraph 8 of TR 92/18. However, we do not accept that the case stands for the proposition that a deduction is available under paragraph 63(1)(b) of the Act for an amount of interest which has not been included in assessable income where the reason for not including the interest was because at the time the debt for the interest arose there was little or no likelihood that the accruing interest would be received.

49. A bad debt deduction may, in some circumstances, be an allowable deduction under subsection 51(1). Where a loss is incurred on revenue account due to the non-receipt of a receivable which has previously been brought to account, the loss is the difference between the amount derived and returned as assessable income and the amount received on disposal or other realisation of the debt. However, a taxpayer who correctly brings interest income to account on a cash basis cannot suffer a loss, in respect of that item, which is deductible under subsection 51(1). See the discussion in *Income Taxation in Australia* by R W Parsons, Law Book Company, 1985 at paragraphs 6.310 and 6.311. As interest on a loan that is correctly classified as a non-accrual loan for income tax purposes is, in our view, assessable on a cash basis it follows that no loss can be suffered for the purposes of subsection 51(1) when the debt is realised.

Treatment of interest not received at the time of classification as a non-accrual loan

50. Under the RBA guidelines when a loan is classified as non-accrual any interest accrued but which has not been received at that time is required to be reversed out to the last reporting date or when interest was last paid (whichever is the more recent). We do not accept that such interest has not been derived for income tax purposes. However, where a loan is classified as non-accrual for the purposes of this Ruling, and the interest accrued but not received satisfies the requirements of a bad debt, as set out in Taxation Ruling TR 92/18, it is considered that the reversing of any accrued interest would amount to the writing off of the debt and that a deduction under section 63 or 51 may be available in respect of the reversed interest. The reversed amount will, however, have to be or will already have been included in the assessable income.

Reclassification of a non-accrual loan to a performing loan

51. Where a loan has been classified as non-accrual and, as a result of the changed financial circumstances of the borrower, the situation which previously prevailed in respect of the recoverability of the amounts outstanding may no longer exist. In such a case we think that interest accruing on the loan should be brought to account in accordance with TR 93/27 and the loan should thereafter not be treated as a non-accrual loan for income tax purposes.

52. If a loan which was previously classified as a non-accrual loan is subsequently reclassified to a performing loan (that is, a loan on which the lender expects to receive all interest and capital payments), any interest that accrued while the loan was classified as non-accrual and which has not been brought to account as income, should be brought to account at the time the loan is re-classified.

Last Ruling

This is the last Taxation Ruling for the 1994 calendar year. The next Ruling will be Taxation Ruling TR 95/1.

Commissioner of Taxation

22 December 1994

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