


TR 96/3 - Income tax: 'periodic interest' in Division 16E of the Income Tax Assessment Act 1936

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Taxation Ruling

Income tax: 'periodic interest' in Division 16E of the *Income Tax Assessment Act 1936*

*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

Class of person/arrangement

1. This Ruling outlines the ATO view on the characterisation of payments as 'periodic interest' for the purposes of Division 16E of Part III of the *Income Tax Assessment Act 1936* ('the Act').

Ruling

2. Interest which is not paid at least annually cannot be 'periodic interest'.

3. If a security's effective rate of interest, as determined at the issue date, is not expected to be constant over the term of the security, a *prima facie* assumption arises that some of the interest payments under the security might not be periodic interest. The effective rate of interest of a security for an interest period is the interest payable in a period of not less than one year divided by the outstanding principal.

4. The effective interest rates of indexed amortising bonds and increasing interest rate (or 'step up') securities will not be constant over the term of the securities and some of the interest paid in those securities will not be regarded as periodic interest by virtue of subsection 159GP(7) of the Act.

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Date of effect

5. Subject to paragraph 6, 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).

6. This Ruling represents a departure from previous ATO practice in relation to the application of subsection 159GP(7) to variable interest payments. Consequently, this Ruling's application to variable interest payments is limited to those made under securities issued after 12 July 1995. Thus, this Ruling would only apply to interest payable under Indexed Amortising Bonds - explained in Example 2 below - issued after 12 July 1995.

Explanations

Division 16E

7. Division 16E was incorporated into the Act by *Taxation Laws Amendment Act (No 2) 1986*, to implement the proposal announced in the Treasurer's Press Release No 184 of 16 December 1984. Prior to the introduction of Division 16E, certain discount and deferred interest securities offered lenders substantial tax deferral opportunities that were not usually available under 'traditional' interest bearing arrangements. The Division was designed to remove these advantages and to achieve symmetry of treatment for lenders and borrowers by spreading income and deductions respectively from deferred interest securities ('qualifying securities' - see below) over the term to maturity of a security on a basis that reflects the economic gains that have accrued at particular points in time.

When does Division 16E apply?

8. A security which is a 'qualifying security' as defined in subsection 159GP(1) of the Act will be subject to the accruals rules of Division 16E. A 'qualifying security' must, among other requirements, have an 'eligible return' (see below). Where the 'eligible return' of a security is known when it is issued, the 'eligible return' must also exceed the result of the equation:

1.5% x Term in years (including any fraction) x non-periodic interest payments.

Eligible return

9. Subsection 159GP(3) defines the term 'eligible return' for the purposes of Division 16E:

'For the purposes of this Division, there shall be taken to be an ***eligible return*** in relation to a security if at the time when the security was issued it is reasonably likely, by reason that the security was issued at a discount, bears deferred interest or is capital indexed or for any other reason, having regard to the terms of the security, for the **sum of all payments (other than periodic interest payments) under the security to exceed the issue price of the security**, and the amount of the eligible return is the amount of the excess.' (emphasis added)

10. Thus, if the return (other than of the issue price) to the holder of a security consists only of 'periodic interest' payments, the security will not have an 'eligible return' and will not be a 'qualifying security', so the accruals provisions of Division 16E will not apply. The characterisation of a payment as 'periodic interest' is therefore significant in considering the application of Division 16E to a 'security'.

Periodic interest

11. The circumstances in which an amount of interest will be 'periodic interest' for the purposes of Division 16E are determined by the application of subsections 159GP(6) and 159GP(7) of the Act.

Subsection 159GP(6)

12. An amount of interest payable will not be 'periodic interest' for the purposes of the Division if the payment is not made in a manner which satisfies the provisions of subsection 159GP(6). The subsection provides that:

'For the purposes of this Division, where an amount of interest is payable under a security, the amount shall be taken to be periodic interest if the period between the commencement of the **period in respect of which the interest is expressed to be payable** and the time at which the interest is payable is less than or equal to one year.' (emphasis added)

13. The first aspect of this provision worth noting is that the payment must be 'an amount of interest'. Therefore, a payment that is economically equivalent to interest, but which is not interest, cannot be periodic interest.

14. Another noteworthy aspect of the provision is that it is concerned with the period in respect of which **the terms of a security** express the interest to be payable, rather than the period to which it apparently relates in an economic sense. Subsection 159GP(6) requires consideration of little other than the formal terms and conditions of a security.

15. Therefore, if the terms and conditions of a particular security are such that interest is paid at least annually, subsection 159GP(6) will take that interest payable to be 'periodic interest' for the purposes of Division 16E, **subject to the operation of subsection 159GP(7)**.

Subsection 159GP(7)

16. A payment which satisfies the provisions of subsection 159GP(6) must also meet the requirement in subsection 159GP(7) that it be 'properly attributable' to a period of a year or less.

17. In essence, subsection 159GP(7) is designed to ensure the potential application of Division 16E to securities which might be created with formal terms and conditions that satisfy the bare elements of form considered by subsection 159GP(6), but which also provide for unequal amounts or rates of interest payable over periods. A security possessing those features might facilitate the type of deferral of interest income that the Division is directed against.

18. Subsection 159GP(7) will apply where, in relation to an interest payment:

'the Commissioner, having regard to the amount of the interest, considers that it is properly attributable to a period in excess of one year' (paragraph 159GP(7)(b)).

19. The effect of the application of subsection 159GP(7) to an interest payment is that the payment will not be regarded as 'periodic interest' for the purposes of Division 16E, and the payment will be attributed to the period to which the Commissioner considers it to be properly attributable. So, even where an amount of interest is expressed to be payable for a period less than or equal to one year, and would otherwise be 'periodic interest' by the operation of subsection 159GP(6), if the Commissioner considers that the provisions of subsection 159GP(7) apply, the payment will not be 'periodic interest'.

20. The Explanatory Memorandum which accompanied *Taxation Laws Amendment Act (No 2) 1986* described the purpose of subsection 159GP(7), at p 63, as follows:

'To guard against issues specifying low interest rates over the early part of a security's term and much larger rates at the end, subsection 159GP(7) provides that, where the Commissioner

considers that an amount that is expressed to be periodic interest in fact is referable to a period in excess of one year, that amount shall not be taken to be periodic interest and shall be regarded as referable to the period the Commissioner considers appropriate. In such cases, the interest would form part of the deferred return under the security and would fall to be assessed by the accruals method.'

21. The determination of the period to which an interest payment is properly attributable is obviously critical to the application of that subsection.

22. In applying the provisions of subsection 159GP(7), the Commissioner will consider in particular the effective interest rate in each interest period of the security. The effective interest rate is determined by the following calculation:

$$\text{Effective interest rate of a period} = \frac{\text{interest payable in period}}{\text{outstanding principal}}$$

23. Subsection 159GP(7) will not apply if the effective interest rate is constant over the life of the security. It will often be apparent that the effective interest rate will be constant, and in such instances it will not be necessary to perform any calculations. One obvious example of this type of security is a loan where the principal advanced is repaid only at the end of the term of the loan and interest is paid at least annually by applying the same interest rate to the outstanding principal.

24. There will be an assumption that subsection 159GP(7) *prima facie* applies whenever the effective interest rates vary, so that some of the interest payments under the security will not be 'periodic interest'.

25. However, the terms and conditions of issue of some securities provide for variable interest payments throughout their terms to maturity. The effective rates of interest - determined by application of the equation in paragraph 22 above to the interest payments - of these variable interest securities will necessarily vary because of the inbuilt variable elements. An indiscriminate application of the propositions in paragraphs 23 and 24 would suggest that subsection 159GP(7) will apply so that at least some of the variable interest payments will not be 'periodic interest'. However, in some instances it will be apparent that the interest payments, although variable, are properly attributable to the periods in which they fall payable and the payments should not attract the application of subsection 159GP(7). In those circumstances it would be inappropriate to treat the interest as other than 'periodic interest'. An obvious example of this type of variable interest security is a floating rate mortgage loan.

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26. Nevertheless, it can be said that the interest payments under some variable interest securities would be properly attributable to a period greater than that in which they are expressed to be payable, and thus - where this period exceeds one year - fall within the intended operation of subsection 159GP(7). This would generally include a security where there is a reasonable expectation at the time of issue of the security that the effective interest rate will rise over its term, even though the outcome might be that the rates do not in fact rise.

27. Reasonable assumptions will be made at the time of issue of a variable interest security about the behaviour of the variable element which effects the calculation of interest payments to determine whether or not the amounts of interest are periodic interest.

28. The appropriate assumptions in each case will depend upon the nature of the particular provision of the terms and conditions of the security which gives rise to the variable interest payment. For example, in determining the effective interest rates of a common floating rate mortgage loan, it is reasonable to assume on issue of that security that interest rates remain over the whole term of the security at the rate prevailing at the time of the security's issue. The propositions in paragraphs 23 and 24 above can also be applied in determining whether a variable interest payment should not be regarded as 'periodic interest' if such reasonable assumptions are appropriately built-in to the calculation of the effective interest rate.

29. The internal rate of return of a security is the discount rate which, when applied to all the cash flows under the terms of a security, equates the sum of the discounted present values of the cash inflows with the sum of the discounted present values of the cash outflows. If the effective interest rate of a security is not constant, the effective interest rates in some interest periods will be lower or higher than the internal rate of return of the security. The Commissioner will consider that part of the interest paid in each of the 'higher interest rate' periods is **attributable** to each of the 'lower interest rate' periods. In the case of a security where the effective interest rate rises over its term, the period to which a 'higher interest rate' payment is attributable begins at the start of the first interest period and finishes when the payment is made.

30. Interest payments in 'lower interest rate' periods are only attributable to the period in which they are made, as they do not supplement the return in any other interest period. Therefore, subsection 159GP(7) will not apply to these interest payments and the application of subsection 159GP(6) alone will determine whether those payments will be 'periodic interest' for the purposes of Division 16E.

31. The distinction between 'higher interest rate' periods and 'lower interest rate' periods can therefore be important in determining whether certain interest payments are periodic interest. As a general rule, if the effective interest rate for an interest period is greater than the internal rate of return of the security, it is a 'higher interest rate' period, and if it is lower, it is a 'lower interest rate' period.

Examples

32. The application of the 'properly attributable' rule in subsection 159GP(7) is best understood by reference to examples. **Example 1** considers a fixed interest security where the interest rate increases each year over its term. **Example 2** considers the case of an 'indexed amortising bond'.

Example 1: increasing interest rate (or 'step up') security

33. A security is issued with the following terms: interest is paid annually in arrears, the issue price and principal is \$100,000, principal is repaid at maturity, a term of 5 years, where the interest rate under the security is 4% pa in year 1, 6% pa in year 2, 8% pa in year 3, 10% pa in year 4 and 12% pa in year 5.

34. It is clear that the effective interest rate rises over the term of this security. The internal rate of return of this security is 7.70%. Therefore, subsection 159GP(7) will apply to the interest payments in years 3, 4 and 5, so they will not be 'periodic interest' for the purposes of Division 16E, and thus form part of the 'eligible return' of the security.

35. The amount of the 'eligible return' under this security is known on its issue to be \$30,000 (i.e., \$8,000 + \$10,000 + \$12,000). In order to be a 'qualifying security', its 'eligible return' must exceed the result of the equation '1.5% x Term (in years) x Sum of all payments **other than** of periodic interest', which in this case is \$9,750 (1.5% x 5 years x \$130,000). As the 'eligible return' of this security exceeds \$9,750 it would be a 'qualifying security' (if issued after the commencement date of Division 16E).

Example 2: indexed amortising bond

36. Indexed amortising bonds ('IABs') are bonds where the holder receives a stream of nominally equal payments, consisting of fixed principal and an interest component. These payments are then linked to an index, such as the Consumer Price Index, to reflect the change in

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the level of that index between the issue date of the bond and the payment date. The part of the payment due to this indexation (i.e., the excess over the minimum payment) is characterised as interest under the terms of the IAB.

37. An example of a fixed payment schedule under an IAB, where the coupon is 5% pa and the issue price is \$1,000, follows:

| Year | Principal | Payment | Interest component | Principal component |
|------|------------|---------|----------------------------|-------------------------------|
| 1 | \$1,000.00 | \$231 | \$1,000 x 5% = \$50 | \$231 - \$50 = \$181 |
| 2 | \$819.00 | \$231 | \$819 x 5% = \$40.95 | \$231 - \$40.95 = \$190.05 |
| 3 | \$628.95 | \$231 | \$628.95 x 5% = \$31.45 | \$231 - \$31.45 = \$199.55 |
| 4 | \$429.40 | \$231 | \$429.40 x 5% = \$21.47 | \$231 - \$21.47 = \$209.53 |
| 5 | \$219.87 | \$231 | \$219.87 x 5% = \$10.99 | \$231 - \$10.99 = \$220.01 |

38. If the CPI was constant over the term of the IAB, then the effective interest rate would be 5% pa each year. However, the effective interest rate calculations should be based on a reasonable estimation of the amount of future interest payments. It is reasonable to assume that the inflation rate (or rate of growth of the CPI) will remain at its prevailing rate over the term of the security (see paragraphs 27 and 28 above). For example, if the inflation rate was assumed to be 2% pa over the term of the IAB, the effective interest rate in each year would be:

| Year | Principal | Payment (indexed) | Principal repayment | Interest | Effective interest rate |
|------|-----------|---------------------------------------|------------------------|------------------------------------|--|
| 1 | \$1,000 | $\$231 \times (1.02)^1$ = \$235.62 | \$181 | $\$235.62 - \181 = \$54.62 | $\frac{\$54.62}{\$1,000}$ = 5.46% |
| 2 | \$819 | $\$231 \times (1.02)^2$ = \$240.33 | \$190.05 | $\$240.33 - \190.05 = \$50.28 | $\frac{\$50.28}{\$819}$ = 6.14% |
| 3 | \$628.95 | $\$231 \times (1.02)^3$ = \$245.14 | \$199.55 | $\$245.14 - \199.55 = \$45.59 | $\frac{\$45.59}{\$628.95}$ = 7.25% |
| 4 | \$429.40 | $\$231 \times (1.02)^4$ = \$250.04 | \$209.53 | $\$250.04 - \209.53 = \$40.51 | $\frac{\$40.51}{\$429.40}$ = 9.43% |
| 5 | \$219.87 | $\$231 \times (1.02)^5$ = \$255.04 | \$220.01 | $\$255.04 - \220.01 = \$35.04 | $\frac{\$35.04}{\$219.87}$ = 15.94% |

39. From this table, it is clear that the effective interest rate rises over the term of the IAB. The internal rate of return of the IAB, based on an assumed inflation rate of 2% pa, would be 7.10%. Therefore, subsection 159GP(7) will apply to the interest payments in years 3, 4 and 5, so they will not be 'periodic interest' for the purposes of Division 16E, and thus form part of the 'eligible return' of the IAB.

40. Therefore, if a positive inflation rate is assumed over the term of the IAB, there would be a reasonable expectation at its issue that it will have an 'eligible return'. As this IAB has an eligible return that is not fixed on its issue, it would be a 'qualifying security' (if issued after the commencement date of Division 16E).

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