GSTR 2005/D2 - Goods and services tax: guarantees and indemnities

Draft Goods and Services Tax Ruling

Goods and services tax: guarantees and indemnities

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Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners, as it is not a ruling or advice for the purposes of section 37 of the ***Taxation Administration Act 1953****. The final Ruling will be a public ruling for the purposes of section 37 and may be relied upon by any entity to which it applies.*

What this Ruling is about

1. This Ruling explains how guarantees and indemnities are treated under the GST legislation. In doing so, it explains the meaning and application of item 7 in the table to subregulation 40-5.09(3) (item 7) of the *A New Tax System (Goods and Services Tax) Regulations 1999* (the GST regulations).

2. In particular, this Ruling describes the different kinds of guarantees and indemnities, and distinguishes between contracts and rights commonly known as guarantees or indemnities that do not fall within item 7, and those contracts and rights that do.

3. The Ruling also identifies the supplies that take place under typical guarantee and indemnity arrangements, and classifies them into those that may be taxable supplies and those that may be financial supplies, and therefore potentially input taxed supplies.

Date of effect

4. This draft Ruling represents the preliminary, though considered, view of the Australian Taxation Office. This draft may not be relied on by taxpayers or practitioners. When the final Ruling is officially released, it will explain our view of the law as it applies from 1 July 2000.

5. The final Ruling will be a public ruling for the purposes of section 37 of the *Taxation Administration Act 1953* and may be relied upon, after it is issued, by any entity to which it applies. Goods and Services Tax Ruling GSTR 1999/1 explains the GST rulings system and our view of when you can rely on our interpretation of the law in GST public and private rulings.

6. If the final public ruling conflicts with a previous private ruling that you have obtained, the public ruling prevails. However, if you have relied on a private ruling, you are protected in respect of what you have done up to the date of issue of the final public ruling. This means that if you have underpaid an amount of GST, you are not liable for the shortfall prior to the date of effect of the later Ruling. Similarly, you are not liable to repay an amount overpaid by the Commissioner as a refund.

Frequently used terms

Terms for the parties to a guarantee or indemnity arrangement

7. The guarantee and indemnity arrangements that this Ruling discusses always have three parties (even if they are not all parties to the guarantee or indemnity itself). These parties can be known by different names in commercial practice.

8. The party who wishes, for example, to borrow money, receive services on credit, or enter into some other arrangement under which there is some form of credit risk, is often known as the:

- debtor;
- principal debtor;
- principal; or
- obligor.

9. In this Ruling, for simplicity and consistency, this party in a guarantee or an indemnity is referred to as the 'principal'.

10. The party who has the risk, and who requires the guarantee or indemnity, is often known as the:

- creditor; or
- obligee.

11. In this Ruling, this party is referred to as the 'creditor' despite the fact that there is not always a debtor-creditor relationship with the principal.

12. Lastly, there is the person who guarantees or indemnifies the creditor against loss. This person is often known as the:

- guarantor;
- surety; or
- indemnifier.

13. In this Ruling, this party is called the 'surety'. Although an indemnifier is not technically a surety, we have chosen this term because we thought consistency in our terminology between the types of arrangements might assist readers in understanding the analysis. (We specify 'surety under a guarantee', or 'surety under an indemnity', where necessary).

14. For example, therefore, in a simple guarantee of a bank loan, the borrower is referred to as the principal, the bank is referred to as the creditor, and the person who stands as guarantor is referred to as the surety.

Terms used for parties to a guarantee of performance under a contract of service

15. Different terms are needed for the parties to contracts that guarantee the performance of services. If a guarantee is given that certain work will be done, or services performed, we use the terms 'service provider' for the party whose services are guaranteed, 'recipient' for the party who receives the services and the benefit of the guarantee, and 'surety' for the party giving the guarantee.

16. Thus, in a simple guarantee of the performance of building work involving a bank guaranteeing the work of a contractor for a land owner: the contractor is the service provider; the land owner is the recipient; and the bank is the surety.

Deeds of guarantee

17. In this Ruling, for simplicity, we refer to guarantees as *contracts of guarantee*, whether the guarantees are created by contract for consideration or by deed, and whether written or unwritten.

Background

Guarantees and indemnities in GST

18. Under section 40-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act), financial supplies are input taxed. The term *financial supplies* is defined in the GST regulations under regulation 40-5.

19. Item 7 of subregulation 40-5.09(3) specifies that the following are interests, the provision, acquisition, or disposal of which can be financial supplies in accordance with subregulation 40-5.09(1):

> A guarantee, including an indemnity (except a warranty for goods or a contract of insurance or reinsurance).

20. Part 5 of Schedule 7 to the GST regulations gives the following examples of things included under item 7:

1 an indemnity that is not a contract of insurance;

2 a surety bond that is a guarantee; and

3 a performance bond.

21. None of these terms is defined in the GST Act or regulations.

Guarantees and indemnities in general law

22. A guarantee is an agreement under which one entity (the surety) agrees to be liable for the obligations of another (the principal), if the principal defaults. An indemnity is an obligation to an entity (the creditor) assumed by another (the surety), under which the surety agrees to keep the creditor harmless from risks arising from dealings with a third party.[1]

23. The distinguishing feature of a guarantee is that there are two obligations: the primary and secondary obligation. The principal has the primary obligation to the creditor, the surety the secondary. In other words, the surety has no liability under the guarantee unless the principal defaults on the primary obligation.

24. Under a guarantee, a surety can not have a primary liability, nor can the surety's liability be greater than the principal's liability. If the primary obligation is extinguished, so is the guarantee. An event that alters the surety's liability may also extinguish the guarantee.

25. The nature of the obligation assumed by the surety is the main distinction between a guarantee and an indemnity. In a contract of guarantee, the surety assumes a secondary obligation in case of the principal's default. In an indemnity, the surety assumes a primary obligation from the time the contract is made, whether or not the principal defaults. That is, the creditor can recover directly from the surety under an indemnity, without awaiting default by the principal. The principal, of course, also has a primary liability to the creditor. Unlike the obligation of the surety under a guarantee, the obligation under an indemnity may differ from what would have been the obligation of the principal.

26. The surety under either a guarantee or an indemnity has a right of recovery for losses against the principal. That is, the surety has a right to be indemnified or reimbursed by the principal.[2] This right may be contractual or arise only in equity.

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[1] Indemnities can also be contracted against the occurrence of some event, but these indemnities are often in the nature of insurance, and are not covered by item 7. For further discussion on insurance-type indemnities, see paragraphs 36 to 39.

[2] In this Ruling we refer to this as the 'underlying indemnity'.

Statute of Frauds

27. Much of the case law on the character of guarantees concerns the *Statute of Frauds*.[3] To be enforceable as a guarantee under the Statute, a guarantee must be in writing.

28. The requirements of the Statute for guarantees have been written into most relevant Australian State and Territory legislation, though in New South Wales and the ACT, guarantees need not be in writing to be enforceable.[4]

29. This body of law is principally concerned with the enforceability of contracts of guarantee. It is clear, however, that a contract of guarantee need not be enforceable under statute to be a guarantee. For the purposes of item 7, therefore, guarantees need not be in writing.

30. Indemnities are not covered by the Statute of Frauds, and need not be in writing for the purposes of item 7.

Warranty

31. The term *warranty* is often used interchangeably with *guarantee* in commercial parlance. However, the two are not equivalent in law, or in GST. Warranties are legally distinct from guarantees,[5] and their treatment under the GST law differs. The distinction between a guarantee and a warranty is further discussed in paragraphs 70 to 76.

32. Warranties may exist within broader contracts. Technically, a warranty is a collateral or incidental term of a contract that gives an injured party a right to damages, but not the right to terminate the contract.[6] In contract law, warranties under contracts are contrasted with *conditions*, which relate to the main purpose of the contract and the breach of which can result in termination.

33. In the context of contracts for the sale of goods, warranties are terms (express or implied) that are collateral to the contract for sale, and which give the purchaser the right to damages if the seller breaches the warranty, but not the right to reject the goods and terminate the contract. A typical example of a warranty in a sale of goods is that the goods will pass to the purchaser in the condition described, and perform their function for a prescribed period.

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[3] *Statute of Frauds* 1677 (UK).
[4] O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee (3rd Ed)*, Law Book Company, Sydney page 67.
[5] The two are distinguished in *The Commissioner of Inland Revenue v. Motorcorp Holdings Ltd and Ors* CA CA17/04 [7 March 2005] paragraphs [60] and [61].
[6] *Halsbury's Laws of England* (4th edn) 9: 543; 18: 1299n.

34. Not everything called a warranty in commercial dealings is a warranty in legal terms. In the commercial world, *warranties* are often contracts in their own right, in which a supplier or manufacturer agrees to repair or replace faulty goods or compensate faulty workmanship where these come to light within an agreed period of time. In some cases, a third party may offer this contractual 'warranty' for goods as an incentive for a purchaser to enter into a contract of sale with another entity or may offer, for a fee, to extend the warranty offered by the supplier. This is discussed further at paragraphs 70 to 76.

35. *Warranty* also has a particular meaning under contracts of insurance.

Insurance

36. A contract of insurance may be classified according to its nature, that is, whether it is one of indemnity or whether it amounts to a contract for the payment of a sum of money on the happening of a contingency.[7] Indemnity insurance holds the insured harmless against loss. This is the object of the most commonly understood type of insurance.[8]

37. Contracts of insurance can be easily distinguished from guarantees and other forms of indemnity. Unlike a surety in a guarantee or simple indemnity, an insurer has no underlying right to be indemnified by the insured. The insurer bears the full risk of the contract. For this reason, contracts of insurance are contracts *uberrimae fidei* – contracts of 'utmost good faith' – and are therefore conditional on the insured disclosing to the insurer facts relevant to the risk the insurer will bear.

38. Another distinguishing feature of insurance is that it must be effected with a direct, explicit, and independent contract. In a guarantee, the three parties can assume their roles as principal, creditor, and surety under separate agreements which, for the purposes of the GST regulations, need not be in writing. Indemnities need not be written and can be recognised in equity, rather than contract, in some circumstances. Insurance, however, requires a contract. This is usually in response to a signed proposal from the insured. Under the contract, the insurer agrees to pay the insured a sum on the happening of a certain event.

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[7] Sutton, K 1999, *Insurance Law in Australia* (3rd Ed), Law Book Company, Sydney, p. 12.

[8] Contingency insurance, by contrast, is insurance contingent on the occurrence of some event. Loss of income insurance is an example of contingency insurance.

39. Summarising, the distinguishing features of insurance are:

- The insurer has primary liability under the contract.
- The insurer bears the risk of loss,[9] that is, the insurer has no right to be indemnified by the insured under the contract.
- The contract is made in utmost good faith, that is, the insured must disclose anything relevant to the insurer's risk.
- The insured is not entitled to profit from the contract, that is, if the insured salvages anything from the loss, the amount salvaged is reflected in the settlement by the insurer.
- The contract is usually made in a commercial context, and the insurer receives a premium.
- The contract of insurance is usually formed by the insurer issuing a policy in response to a proposal by the insured.
- A contract of insurance is void if the insured has no insurable interest in the subject matter.
- The insurer must be an entity authorised to carry on an insurance business in Australia.

Reinsurance

40. Only an insurer can reinsure. Reinsurance is the method insurers use to lay off or cede part or all of their risk under a policy. A reinsurance policy is insurance against an insurer's risk of having to pay out on a policy the insurer has issued. It is, therefore, a form of indemnity and, like other insurance, a contract of utmost good faith between the insurer and reinsurer.

41. An insurer may reinsure with a number of insurers, to spread large risks. If the insured makes a claim upon which the insurer must pay, each reinsurer is only liable for the amount under their policy of reinsurance, not for the whole amount of the insurer's liability under the policy.

42. For there to be reinsurance, there must be an original insurance contract (that is, a contract between insurer and insured, which then becomes the subject of reinsurance by the insurer).

43. Reinsurance has the characteristics of insurance. Like other forms of insurance, reinsurance is not a financial supply. The only exception to this is life insurance, which is a financial supply, as is its reinsurance.

[9] Except to the extent of any excess the insured must pay on a claim.

44. Refer to paragraphs 80 to 82 regarding the special industry use of the term 'reinsurance' in the context of surety bonds.

Performance bonds

45. In a performance bond, a surety is liable for the performance, by a service provider, of the conditions under the service provider's contract with the recipient of the services.[10] The surety's obligation is to make good the service provider's obligation. Performance bonds do not usually cover an obligation to make payment, but rather an obligation to perform services, or carry out other work or meet conditions in a contract. They may take the form of a guarantee (that is the surety has a secondary liability), but are commonly indemnities (where the surety takes on a primary liability along with the service provider).

Ruling and Explanation

The meaning of item 7: 'guarantee, including an indemnity'

46. Goods and Services Tax Ruling GSTR 2003/16[11] gives some guidance on interpreting the phrase 'guarantee, including an indemnity' in item 7. The Ruling states that item 7 includes only the kinds of indemnities referred to by the High Court in *Sunbird Plaza Pty Ltd v. Maloney*.[12]

47. At paragraphs 74 and 75 GSTR 2003/16 says:

> 74. The expression 'indemnity' takes different meanings according to its context. At its broadest, it is used to refer to an undertaking to hold another harmless against loss. In this broad sense, it may embrace recompense for any loss or liability which one person has incurred, arising out of contract or by operation of law. An example of the latter is a guarantor's right of indemnity from a principal.
>
> 75. The High Court in *Sunbird Plaza Pty Ltd v. Maloney (Sunbird Plaza)* has described an indemnity as 'a promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction *with a third* party' (emphasis added). Given its use in Item 7 as part of the expression 'Guarantee including an indemnity' in the context of guarantees and indemnities of the type supplied for consideration, we consider that 'indemnity' is used in Item 7 in the sense articulated by the High Court in *Sunbird Plaza* .Income guarantees are not such indemnities as the harm against which protection is provided does not arise as a consequence of a transaction with a third party.[13]

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[10] See paragraphs 15 to 16 for an explanation of 'service provider' and 'recipient'.
[11] GSTR 2003/16 Goods and services tax: inducements to enter into a lease of commercial premises.
[12] *Sunbird Plaza Pty Ltd v. Maloney* (1988) 166 CLR 245; (1988) 77 ALR 205.
[13] GSTR 2003/16 paragraph 75 footnotes, *Sunbird Plaza* (1988) 166 CLR 245 at 254; (1988) 77 ALR 205 at 207.

48. The guarantees and indemnities covered by item 7 have characteristics in common: they all involve three parties, and underlying indemnities flow from the relationships between the parties. The nature of the risk undertaken by the surety in these arrangements is credit risk: that is, the risk that the principal will be unable to reimburse the surety if it is required to make a payment.

49. For the purposes of determining whether an interest is covered by item 7, it is not necessary to distinguish between a guarantee and an indemnity. Where an arrangement has the characteristics referred to above, it is covered by item 7, regardless of whether, on closer legal analysis, it is a guarantee or an indemnity.

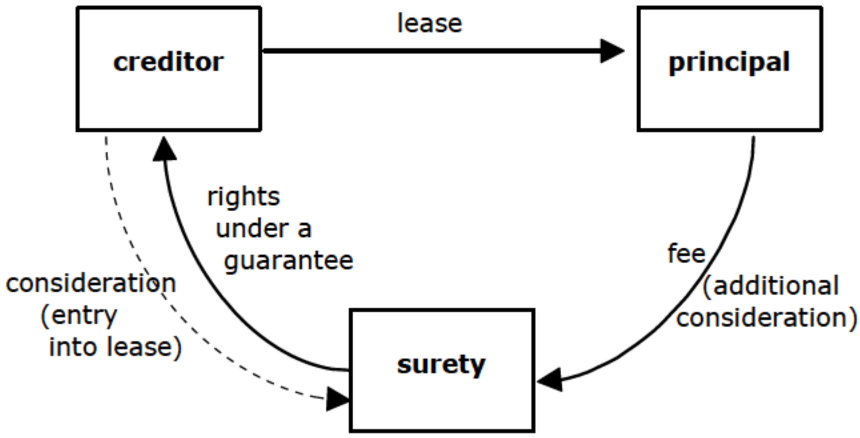
Guarantees

50. There are three parties to a guarantee: the principal, the creditor and the surety. Guarantees are contractual arrangements under which the surety agrees to make good the obligation of the principal if the principal defaults.

51. Guarantees (and indemnities) may be recompensed or non-recompensed. In a recompensed guarantee, the surety is paid a fee, usually by the principal. Most guarantees provided in a commercial environment are recompensed guarantees. However, the common form of guarantee under which the directors of a family company guarantee the company's obligations are usually non-recompensed guarantees.

52. The diagram below sets out the flow of obligations and consideration under a typical recompensed guarantee for lease payments. The creditor supplies a commercial lease to the principal. The principal pays the surety to provide rights under a guarantee to the creditor (a financial supply). The surety, in this case, receives consideration from two sources, the creditor and the principal.

Figure 1: Flow of supplies and consideration under a guarantee



Supply of an interest in a guarantee

53. Paragraph 14 of Taxation Ruling TR 96/23,[14] which is about the capital gains tax implications of a non-recompensed guarantee to pay a debt, says:

> On entering into a guarantee contract, a creditor acquires a further asset (in addition to the underlying debt) being the contractual rights under the guarantee, that is, rights including a right to call on the guarantor for payment.

54. The supply of an interest in or under a guarantee must be for consideration unless the guarantee is under seal:

> The consideration for the guarantee must move from the person to whom the guarantee is given; although indeed the whole consideration need not move from that person. In the context of a guarantee, the consideration will be in the form of a creditor incurring some detriment in reliance on the promise to guarantee rather than conferring some benefit upon the guarantor.[15]

55. We identify the consideration provided by the creditor as the entry into the arrangement with the principal.

56. Whether or not the principal pays a fee to the surety, the principal has no rights under the guarantee, and does not acquire an interest in a guarantee for the purposes of item 7. That is, the surety does not make a supply of an interest in a guarantee to the principal. It does, however, make a supply of such an interest to the creditor (this is shown in Figure 1).

57. If the principal pays the surety a fee, it is further consideration for the supply of an item 7 interest in a guarantee, that is, in addition to the consideration provided by the creditor.

58. The surety, in creating the interest in the guarantee, makes a supply to the creditor and is therefore the financial supply provider of the interest. If the other conditions of subregulation 40-5.09(1) are met, the surety makes a financial supply.

59. The creditor, in acquiring the interest, may also make a financial supply.[16]

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[14] TR 96/23 Income tax: capital gains: implications of a guarantee to pay a debt.

[15] O'Donovan, J & Phillips, J 1996, *The Modern Contract of Guarantee* (3rd Ed), Law Book Company, Sydney, p. 52.

[16] Provided the other conditions of subregulation 40-5.09(1) are met. Given that under subregulation 40-5.06(2), the acquirer of a financial interest is also the financial supply *provider* of the interest, it is usual for the acquirer of an interest under subregulation 40-5.09(1) to also be making a financial supply. This is known as the 'acquisition-supply'. For more detail on the acquisition-supply, see GSTR 2002/2 Goods and services tax: GST treatment of financial supplies and related supplies and acquisitions.

The underlying indemnity

60. In most guarantees, the surety has the right to be indemnified by the principal. This occurs as a matter of course when a surety enters into a guarantee at the request of the principal, or the principal has knowledge of, or concurs with, the granting of the guarantee. As noted at paragraph 30 of TR 96/23:

> On entering into a contract of guarantee, the guarantor acquires an asset which is a right to be indemnified by the principal debtor. That right of indemnity arises by way of an express or implied term in the contract of guarantee, if the contract is a tri-partite agreement. Otherwise, the right of indemnity arises under an implied contract of indemnity between the principal debtor and the guarantor on entry into the contract of guarantee. Until default by the principal debtor and payment by the guarantor, a guarantor is not entitled to sue on the right of indemnity (whether it is a legal or an equitable right). Of course, the debtor may not default, the debt may be otherwise paid or it may be released.

61. If the principal is not a party to the contract, and neither requested nor was aware of it, the surety's ability to obtain reimbursement relies on a restitutionary claim.

62. The underlying indemnity in a guarantee, whether it arises under contract or otherwise, is not an indemnity for the purposes of item 7. We consider that the intention of listing a 'guarantee, including an indemnity' in item 7 was to ensure that supplies of interests in guarantees and those indemnities covered by the item would be financial supplies. However, we do not consider that the intention was to require such guarantees and indemnities be further analysed to expose the underlying indemnities that arise incidentally under those contracts, and treat them as separate supplies. Accordingly, we consider that these underlying indemnities do not give rise to separate supplies and therefore the incidental creation of such underlying indemnities is not a financial supply.

Indemnities

63. An indemnity, for the purposes of item 7, is an arrangement involving three parties. However, in an indemnity the surety takes primary responsibility for an obligation arising in relation to a third party. That is, the creditor may recover directly from the surety, regardless of whether the principal defaults.

64. Indemnities may also be recompensed or non-recompensed. Under the GST regulations, supplies of interests under an indemnity are treated in the same way as those made under a guarantee.

65. In common with guarantees, the surety under an indemnity to which item 7 applies has a right to be indemnified or reimbursed by the principal. This underlying indemnity may arise either contractually or in equity, depending on whether the principal requested or had knowledge of the granting of the indemnity.

66. As with underlying indemnities arising under guarantees, we consider that the incidental creation of underlying indemnities under indemnities is not a financial supply.

Payment under a guarantee or indemnity

67. If the surety is called upon to make a payment to the creditor under a guarantee or indemnity, the payment is made as a result of the exercise of the creditor's rights under the guarantee or indemnity.[17]

68. Where there is a payment of money, this is not consideration for the release of the surety from an obligation under subsection 9-10(2), nor is it consideration for the surrender of the creditor's rights under paragraph 9-10(2)(e). Rather, the payment discharges (or partly discharges) the surety's obligations under the contract.[18] Accordingly, there is no supply to the surety by the creditor in consideration of the payment by the surety.

69. The payment of money on the exercise of a right is also not a supply by the surety because of subsection 9-10(4).[19]

Warranties

70. Supplies of warranties are not financial supplies under item 7, except where they have the characteristics of a guarantee. This does not commonly occur.

71. In commercial parlance, the terms *warranty* and *guarantee* are sometimes used interchangeably. In general, the term *guarantee* describes a collateral contract 'by which one person is bound to another for the due fulfilment of a promise or engagement of a third party', while the term *warranty* describes 'a contract as to title, quality or quantity of a thing sold'.[20] Written or oral assurances as to the quality or performance of consumer goods are warranties at law, not guarantees.

72. Item 7 excludes a warranty for goods. Goods, according to the dictionary in the GST Act, are 'any form of tangible personal property'.[21] A warranty for the quality of services, or property other than goods, although not specifically excluded, does not fall within item 7 unless it has the character of a guarantee.

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[17] For the purposes of capital gains tax, the exercise of the creditor's rights is a disposal of its rights under the guarantee and a CGT C2 event under section 104-25 of the *Income Tax Assessment Act 1997*.

[18] This is analogous to the discharge of the judgement debtor's obligation referred to by Underwood J in *Shaw v. Director of Housing and State of Tasmania (No. 2)* [2001] TASSC 2.

[19] Subsection 9-10(4) states that a supply of money is not a supply, unless it is provided as consideration for another supply of money.

[20] O'Donovan, J & Phillips, J 1996, The Modern Contract of Guarantee (3rd Ed), Law Book Company, Sydney, p. 31.

[21] GST Act, section 195-1.

73. A warranty does not usually relate to the obligations of a third party. However, in some cases a warranty may be given by an entity to induce a customer to purchase goods or services from another entity. In this case, the provider of the warranty agrees to make good defects in goods or services provided to the customer, if those goods or services are not of the standard warranted by the supplier.

74. An extended warranty offered on goods, where for a fee a third party agrees to make good any faults in goods sold by a retailer for a specified period, is another example of a three party warranty. Neither this, nor the example in paragraph 73 is a guarantee for the purposes of item 7.

75. These warranties are three-party agreements containing 'a promise by the promisor that he will keep the promisee harmless against loss as a result of entering into a transaction with a third party'.[22] However, few three-party warranties contain an underlying indemnity, under which the surety (in this example the third party) has the right to be indemnified by the principal (in this case the retailer), for any payment made to the creditor (in this case, the customer). These warranties do not, therefore, have the relevant characteristics of a guarantee identified in paragraph 48, and are not financial supplies under item 7.

76. It is possible that guarantees may exist that take the superficial form of a warranty for goods or services. However, where these have three parties in the proper relationships, and an underlying indemnity between the entity providing the 'warranty' and the goods or service provider, the proper characterisation is as a guarantee, notwithstanding that goods or services are the subject matter of the agreement. Performance bonds for construction work are an example of this type of guarantee.

Example 1

77. *Norman's, a motorcycle repairer and spare parts dealer, offers a five year warranty to purchasers of selected models of the Nippy 2000 motorbike. The Nippy 2000 comes with a one year warranty from the dealer. For a payment of $400 Norman's agrees to repair any faults in the bike for four years after the initial warranty period. Valentino Bianco agrees to buy a Nippy 2000 from Mr. Toad's Motors and purchases the extended warranty.*

78. *When, one year and 10 days later, the bike develops some problems due to a faulty part, Valentino takes it back to Mr Toad's which sends it to Norman's to make the repairs. Norman's bears the costs under the extended warranty.*

79. *Despite there being three parties to the agreement, this is not a guarantee under Item 7, as Norman's has no right to be indemnified by Mr Toad's Motors. The supply of the extended warranty is a taxable supply for which the $400 is consideration.*

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[22] *Sunbird Plaza Pty Ltd v. Maloney* (1988) 166 CLR 245 at 254; (1988) 77 ALR 205 at 207.

Reinsurance of surety bonds

80. Reinsurance, as discussed at paragraphs 40 to 44 (in 'Background'), is a form of insurance, and always relates to underlying contracts of insurance.

81. However, an arrangement in relation to surety bonds under which the risk of the surety is ceded in part or wholly to another entity is referred to, in the surety industry, as 'reinsurance'. In these arrangements, the underlying contract is not a contract of insurance, but rather a guarantee. The so-called 'reinsurance' contract is also not a contract of insurance.

82. This 'reinsurance' of surety bond products has the same character as a surety bond product itself. That is, such arrangements involve a supply of an interest in or under a guarantee or an indemnity and are not contracts of insurance. The 'reinsurer' therefore makes a financial supply by entering into the ceding arrangement. As the recipient of the 'reinsurance', the surety also makes a financial supply, being an acquisition supply.

Examples of interests included in item 7

83. The following paragraphs discuss the transactions included in Schedule 7 to the GST regulations, which, at Part 5, provides examples of interests included under item 7.

An indemnity that is not a contract of insurance

84. The first example for item 7 is 'an indemnity that is not a contract of insurance'.[23] Insurance is a special form of indemnity and is specifically excluded from item 7. The characteristics of those guarantees and indemnities covered by item 7 and contracts of insurance are quite different. See paragraphs 36 to 39 for the distinguishing features of insurance.

85. Some contracts of indemnity are neither indemnities of the kind referred to in *Sunbird Plaza*, nor contracts of insurance. These types of indemnity are not covered by item 7.

86. An example is a 'commercial' indemnity in which one entity agrees to make good the loss of a second entity in certain circumstances not involving a transaction with a third party. This type of indemnity includes income 'guarantees' in which a vendor of a business agrees to pay the difference between the estimated income from the business and the actual income to the purchaser for a given period.

87. If this type of indemnity is provided for consideration, it may be a taxable supply by the entity making the promise.[24]

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[23] GST regulations, Schedule 7, Part 5.
[24] GSTR 2003/16 paragraphs 69 and 72.

A surety bond that is a guarantee

88. The second example for item 7 is surety bonds. Surety bonds are commercial products under which the surety undertakes to secure certain obligations owed by a principal to a creditor. Performance bonds are particular types of surety bonds.

89. Surety bonds have the character of guarantees. The provision, creation, or acquisition of an interest in a surety bond may be a financial supply.

90. Supplies of interests under contracts described as surety bonds, but which are not guarantees or indemnities under item 7, are not financial supplies.

A performance bond

91. The third example of an item 7 interest is 'a performance bond'.

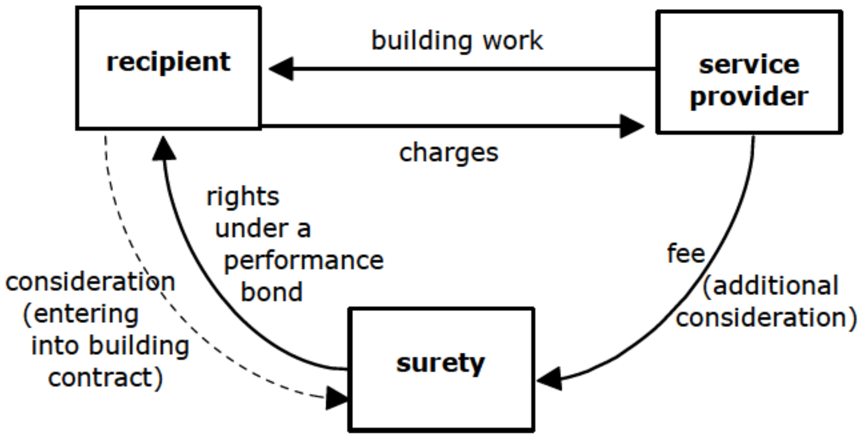
What is a performance bond?

92. A performance bond is an undertaking by a person to make good a contractual obligation of another to a third party, usually on proof of the failure of that other person to perform the relevant obligation.

93. When an entity agrees to guarantee the work or performance of another under a performance bond, the entity makes a financial supply in the same manner, as discussed at paragraphs 53 to 59 ('Guarantees'). The supply of rights under a performance bond is a financial supply, and the consideration consists of the recipient's engagement of the service provider, together with any fees the service provider pays for the guarantee.

94. The diagram below sets out the flow of obligations and consideration under a typical performance bond for building work. The recipient enters into a building contract with the principal. The service provider pays the surety to provide rights under a performance bond to the recipient (a financial supply). The surety receives consideration from two sources: the recipient and the service provider.

Figure 2: Flow of supplies and consideration under a performance bond



95. Performance bonds are used in large scale project financing transactions. An example arising in the construction industry is an unconditional undertaking from a financial institution or insurance company addressed to a proprietor of land, in which the institution or company promises to pay the proprietor the amount set out in the undertaking on demand from the proprietor.[25]

96. Some performance bonds contain an option for the surety to perform the contract rather than pay the relevant amount, while, rarely, others will require performance only.

97. Performance bonds may be conditional or unconditional. A conditional performance bond imposes a secondary obligation on the surety and is only enforceable on breach by the service provider.

98. An unconditional performance bond permits the recipient to call first upon the surety, and does not require proof of a breach before it is invoked.

99. Performance bonds may also be known as 'bank guarantees' or 'insurance bonds'. These terms indicate the nature of the entity providing the assurance, and generally refer to unconditional performance bonds.

100. Insurance bonds that are issued by an insurance company are distinct from contracts of insurance. Although the example itself does not make this qualification, to the extent that a product is a contract of insurance, the example in Schedule 7 will be inconsistent with the description in item 7 and the description will prevail.[26] In these circumstances, the product would not be covered by item 7.

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[25] *Butterworths Australian Legal Dictionary*, 1997, Butterworths, Sydney, p. 866.
[26] See Note 2 to regulation 40-5.11 and section 15AD of the *Acts Interpretation Act 1901*.

101. Whatever name is given to the product, it falls within item 7 if it has the characteristics of a guarantee. The effect of payments or supplies made under these products is dealt with below.

Supplies made under performance bonds

102. In commercial practice, performance bonds are given for the quality, timeliness, or some other measure of supplies being made to an entity. In this case, the recipient has contracted for the service provider to make a supply to the recipient. The surety guarantees the quality or timeliness of the completed work.

103. If the work is not satisfactorily completed, the recipient has the right to call on the surety for payment (often without calling on the service provider in the case of an unconditional bond). The surety may choose to complete or repair the work instead of making the payment, if this is allowed in the bond document, and there is no legal impediment.

104. Whether the surety pays an amount or makes a supply, the payment or supply (as discussed in paragraph 68) is not consideration for the release from an obligation.

105. If the surety makes a cash payment, the payment is not a supply.[27]

106. If the surety makes a supply of work and the recipient provides no additional consideration to the surety when it performs the work, there is no consideration for the supply. There is, therefore, no taxable supply by the surety.[28]

107. In some performance bond contracts, the recipient is not interested in compensation for uncompleted work, but simply wants assurance that the surety will complete the work if the service provider does not. Even where no provision is made in the performance bond for a cash payment the surety's supply of the rights under the performance bond to the recipient is a financial supply, in common with other performance bonds and standard guarantees.

108. If the payments under the underlying contract (for example, a construction contract) have all been made to the original contractor, and no payments are made to the surety for the completion of the contract, the supply of completing the contract is for no consideration, and is not a taxable supply by the surety.

109. If, under the terms of the contract between the parties, the recipient pays part of the consideration for the work to the surety, this is consideration for a taxable supply of the work the surety performs, as distinct from a supply of rights under the performance bond.

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[27] Subsection 9-10(4).
[28] Subparagraph 9-15(3)(a)(ii).

110. Under all of these circumstances, the surety has a right to be indemnified by the service provider. However, this underlying indemnity is not regarded as a separate supply (see paragraph 115).

Payment or supplies under a performance bond in the hands of the recipient

111. The recipient in a contract for services (for example, building services) contracts for an outcome. A performance bond guarantees that outcome.

112. If the supply that the service provider makes to the recipient is inferior or incomplete, and the recipient receives a payment from the surety, this payment is made to meet the surety's obligations under the performance bond. It is not an adjustment to the price of the original supply, nor is it consideration for a separate supply by the recipient.

113. The effect of the surety choosing to complete or repair the work is as follows. The recipient contracts for a completed job of a certain standard, and the job is completed to that standard by the surety. The recipient achieves what it contracted for, but by way of supplies by two entities instead of one. One of the entities (the service provider) makes a taxable supply, while the other (the surety), provided it received no payment from the recipient, makes a supply for no consideration.

114. If some of the payments for the work are actually made to the surety, both entities make a taxable supply in completing the job the recipient contracted for.

115. Whether the surety makes a payment or completes the work, it is entitled to be indemnified by the service provider for the payment or the value of the work done. As with other guarantees and indemnities, (see paragraphs 60 and 62) we consider that underlying indemnities arising incidentally out of performance bonds are not separate supplies, and, therefore, do not involve financial supplies.

Your comments

116. We invite you to comment on this draft Goods and Services Tax Ruling. Please forward your comments to the contact officer(s) by the due date.

Due date:	**11 November 2005**
Contact officer:	**Johanna Stewart**
E-mail address:	**johanna.stewart@ato.gov.au**
Telephone:	**(07) 3213 5761**
Facsimile:	**(07) 3213 5055**
Address:	**GST Financial Supplies and Insurance GPO Box 920 Brisbane QLD 4001**

Detailed contents list

117. Below is a detailed contents list for this draft Goods and Services Tax Ruling:

Commissioner of Taxation
28 September 2005

Previous drafts:
Not previously issued as a draft

Related Rulings/Determinations:
GSTR 1999/1; GSTR 2002/2; GSTR 2003/16; TR 96/23

Subject references:
- contract
- creditor
- debtor
- deed of guarantee
- financial interest
- financial supply
- financial supply provider
- guarantee
- guarantor
- indemnifier
- indemnity
- input taxed supply
- insurance
- obligee
- obligor
- performance bond
- principal
- reinsurance
- rights
- Statute of Frauds
- surety
- surety bond
- three-party contract
- utmost good faith
- warranty
- warranty

Legislative references:
- AIA 1901 15AD
- ANTS(GST)A 1999 9-10(2)
- ANTS(GST)A 1999 9-10(2)(e)
- ANTS(GST)A 1999 9-10(4)
- ANTS(GST)A 1999 9-15(3)(a)(ii)
- ANTS(GST)A 1999 40-5
- ANTS(GST)A 1999 195-1
- ANTS(GST)R 1999 40-5.06(2)
- ANTS(GST)R 1999 40-5.09(1)
- ANTS(GST)R 1999 40-5.09(3)
- ANTS(GST)R 1999 40-5.11
- ANTS(GST)R 1999 Sch 7 Pt 5
- ITAA 1997 104-25
- Statute of Frauds 1677 (UK)
- TAA 1953 37

Case references:
- The Commissioner of Inland Revenue v. Motorcorp Holdings Ltd and Ors CA CA17/04 [7 March 2005]; [2005] NZCA 33
- Shaw v. Director of Housing and State of Tasmania (No. 2) [2001] TASSC 2; 2001 ATC 4054; 46 ATR 242
- Sunbird Plaza Pty Ltd v. Maloney (1988) 166 CLR 245; (1988) 77 ALR 205

Other references:
- Butterworths Australian Legal Dictionary, 1997, Butterworths, Sydney
- Halsbury's Laws of England (4th edn)
- O'Donovan, J & Phillips, J 1996, The Modern Contract of Guarantee (3rd Ed), Law Book Company, Sydney
- Sutton, K 1999, Insurance Law in Australia (3rd Ed) Law Book Company, Sydney

ATO references
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Goods and Services Tax ~~ Financial supplies ~~ other