# TR 92/D40 - Income tax: basis of assessment of interest derived from securities purchased and sold cum interest

This cover sheet is provided for information only. It does not form part of *TR 92/D40 - Income tax: basis of assessment of interest derived from securities purchased and sold cum interest*This document has been finalised by <u>TR 93/28</u>.

FOI status draft only - for comment

page 1 of 12

### **Draft Taxation Ruling**

Income tax: basis of assessment of interest derived from securities purchased and sold cum interest

other Rulings on this topic IT 2276; TR 92/D38 CITCM 811; ITR 88 (Vic.)

contents para		
What this Ruling is about		
Ruling		
Date of effect 4		
Explanations		
-	Fixed and variable intersecurities	est 5
-	Non-interest gains and losses	15
-	Interest derived	21
Examples 34		

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office.

DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings which represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

### What this Ruling is about

1. This Ruling clarifies the appropriate taxation treatment under the *Income Tax Assessment Act 1936* ('the Act') of interest derived by businesses from investments in certain fixed and variable interest securities where such securities are purchased or sold cum interest rights. This Ruling does not apply to circumstances where the principal and interest components of a security are dealt with separately. In addition, this Ruling applies not only to 'financial institutions' as defined for the purposes of Draft Taxation Ruling TR 92/D38 but also to any business that invests in such securities.

### Ruling

- 2. Where to the principal and interest components of securities are not dealt with separately, businesses that invest in fixed or variable interest securities cum interest should bring interest derived from those securities to account for tax purposes on a due and receivable basis. An example of the due and receivable approach is set out at paragraph 34 of this Ruling.
- 3. The interest income should not be returned on a daily accruals basis or returned at the time of disposal of the security through an adjustment to its cost price.

page 2 of 12

FOI status draft only - for comment

### Date of effect

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

### **Explanations**

#### Fixed and variable interest securities

- 5. Securities may be described as inscribed (that is, where a register of investors is maintained) or uninscribed (that is, where a register of investors is not maintained as is the case with bearer securities). Most fixed interest securities fall within the general category of transferable inscribed money market securities. Bonds sometimes have a coupon attached to enable the holder to collect interest. The coupons are numbered and dated and marked with the amount of interest payable on their surrender. Detachable coupons are a feature of bearer bonds but these types of securities now represent a minor part of the overall securities market.
- 6. For ease of reference the term 'coupon date' will be used throughout this Ruling to denote the time at which rights to interest arise for each interest period under a fixed or variable interest security.
- 7. Clarification has been sought as to the appropriate tax accounting treatment to be adopted by businesses for interest derived from investments in certain fixed or variable interest securities where such securities are acquired or disposed of between interest coupon dates. That is, should the daily accruals method be applied so that the interest is brought to account on a day by day basis over the term for which the security is held or is the interest derived on a due and receivable basis? The issue arises in respect of fixed and variable interest securities where the principal and interest components are not dealt with separately.
- 8. The Australian Financial Markets Association ('AFMA') publication 'Fixed Interest Markets' indicates that the fixed interest markets in Australia involve issuing and trading in Commonwealth government bonds, semi-government securities (for example, New

South Wales Treasury Corporation bonds), Commonwealth government corporate bonds (for example, Telecom bonds), State corporate bonds and, to a lesser extent, corporate bonds, mortgage-backed securities and, most recently, Matilda bonds (securities denominated in \$Aust., issued in Australia by foreign sovereign and multi-national borrowers). Commonwealth bonds are sold by the Reserve Bank of Australia ('Reserve Bank') as agent for the Commonwealth government. Participants in the fixed interest bond markets include banks, investment banks, brokers, life offices, pension funds and overseas investors. The market in fixed interest securities is very much professional and wholesale, with relatively minimal participation from retail (household) investors.

- 9. The fixed interest markets have a key role in the financial system. As well as providing investments for banks, life offices and pension funds, other financial intermediaries and companies, they also provide a fund raising mechanism for the Commonwealth and State governments, and companies.
- 10. An example of a variable interest security is a security under which interest payable on the security at the due date is calculated based upon the Consumer Price Index plus a margin. AFMA advise that the volume of variable interest securities traded is presently small but anticipated to grow. Variable interest securities can be issued by the previously mentioned categories of issuers.
- 11. Generally, a purchaser wishing to buy a parcel of securities approaches the seller to complete a transfer and acceptance form ('T & A form'). Upon execution the purchaser provides the seller with a bank cheque and then lodges the T & A form with the relevant registry.
- 12. Most securities registers in Australia are not computerised although computerisation is progressing. In the future it is likely that the name of the purchaser of widely traded fixed interest securities will be automatically recorded on a central register so that the identity of the investor or trader who has the rights to interest payable is able to be readily ascertained. Presently most security registers in Australia are on a manual system and it is generally the case that registers are closed off for periods ranging from 7 to 15 days to allow the registrars to update their security ownership records, process coupon payments and issue interest cheques. The period during which a security register is closed off is commonly referred to as the 'ex interest' period.
- 13. During the ex interest period sales of securities may continue to be made. However, changes in ownership are not registered during this period and purchasers do not obtain any rights to interest. The consideration payable for securities sold ex interest during these periods is reduced accordingly.

page 4 of 12

FOI status draft only - for comment

14. With the exception of securities sold during an ex interest period, a common characteristic of the securities dealt with in this Ruling is that the securities are purchased and sold cum interest rights. That is, when a security is sold 'cum interest' the purchaser receives for its own benefit the full amount of interest that has accrued since the last coupon date. This Ruling addresses the circumstances where such securities are purchased or sold cum interest rights between coupon dates and clarifies the appropriate taxation treatment of interest derived by businesses from investments in those securities.

### Non-interest gains and losses

- 15. Before proceeding to deal specifically with the appropriate method under which interest derived from fixed and variable interest securities should be brought to account for taxation purposes it is necessary to first examine the related question of how non-interest gains and losses on disposal of such securities should be treated for taxation purposes.
- 16. Subject to Division 16E, non-interest profits gained, or losses incurred, by businesses as a result of the sale or redemption of interest bearing securities will generally fall for assessment under either the general provisions of the Act (subsections 25(1) and 51(1)) or, where the security is acquired after 10 May 1989, the traditional securities provisions (sections 26BB and 70B). Prior to the introduction of the traditional securities provisions the assessability and deductibility of non-interest gains and losses which arose from the sale or redemption of a security generally depended upon the nature of the seller's activities, the type of security and the circumstances of its acquisition. Thus gains and losses made on the sale or redemption of securities were characterised having regard to whether the securities were revenue assets, pre- or post- 19 September 1985 capital assets, or (for dealers and traders in securities) trading stock.
- 17. The general principle governing the assessability of the profit (or conversely the allowability of losses) arising on the sale of investments is that propounded by the Lord Justice Clerk in *Californian Copper Syndicate v. Harris* (1904) 5 TC 159 at 166; expressed in the following terms:

'It is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable, where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out of a business.'

The principle so stated has been applied in relation to trading banks (cf. *Punjab Co-operative Bank Limited, Amritsar v. Commissioner of* 

Income Tax, Lahore (1940) AC 1055, and to insurance companies (cf. Colonial Mutual Life Assurance Society Limited v. FC of T (1946) 73 CLR 604; and Australasian Catholic Assurance Co. Limited v. FC of T (1959) 100 CLR 502). These cases extended the principle to apply to investments generally and not merely to those which consist of government securities. (See also (1964) 14 TBRD 236 Case P52 at 236-7; 11 CTBR (NS) 437 Case 75 at 437-8).

- 18. The acquisition of interest bearing securities, whether by purchase or subscription, and their realisation by sale, redemption or conversion, is an integral part of the business carried on by a financial institution (cf. (1964) 14 TBRD 236 Case P52; 11 CTBR (NS) 437 Case 75; Case F26 74 ATC 132 at 155; (1974) 19 CTBR (NS) 291 Case 44at 316). In so far as a taxpayer purchases securities rather than subscribes for them on issue it could not be said that the taxpayer is engaged in the lending of money. Thus, when a financial institution purchases interest bearing securities it does not lend funds. Generally speaking, financial institutions invest in such securities on market in their normal business operations as part of their general short term liquidity management thereby ensuring necessary cash resources to meet their commitments.
- 19. Gains and losses made by taxpayers that carry on a business of investment are considered to be assessable or deductible under subsection 25(1) or subsection 51(1) of the Act. Canberra Income Tax Circular Memorandum No. 811 sets out our long standing view that realised profits and losses arising from transactions involving Commonwealth Loans and other securities that are derived or incurred in the course of carrying on a banking or insurance business are properly to be taken into account in arriving at the taxable income of that business. Taxation Ruling IT 2276 also deals with the liability to income tax of profits and losses made by general insurance companies on realisation of investments.
- 20. On the other hand, where profits derived by a business from its dealing in securities do not constitute income under ordinary concepts, and the securities are acquired after 10 May 1989, it is likely that such gains are assessable (or conversely, such losses are deductible) under the traditional securities provisions of the Act. In order for a security to qualify for treatment as a traditional security for the purposes of sections 26BB and 70B, it must satisfy the definition of 'security' contained in subsection 159GP(1) and the definition of 'traditional security' contained in subsection 26BB(1).

#### **Interest derived**

page 6 of 12

FOI status draft only - for comment

- 21. The common law principle is that interest accrues on a or day by day basis (that is, *de die in diem*) even if payable only at intervals (cf. *The State of South Australia v. The Commonwealth of Australia* 92 ATC 4066 at 4072; (1992) 23 ATR 10 at 19; *Chow Yoong Hong v. Choong Fah Rubber Manufactory* (1961) 3 All ER 1163 at 1167; (1962) AC 209 at 217; *Willingale (H.M. Inspector of Taxes) v. International Commercial Bank Limited* (1978) 52 TC 242 at 269 & 271; *In re Rogers' Trusts* (1860) 62 ER 408 at 409)). Interest is therefore apportionable under the general law in respect of time (cf. *Halsbury's Laws of England*, 4th ed., Vol. 32 at para 106; Vol. 16 at para 1250; *Conveyancing Act 1919 (NSW)*, subsection 144(1)).
- 22. However, it also appears that the common law principle that interest accumulates day by day may be overridden by the terms of a suitably worded loan agreement. In *FC of T v. Australian Guarantee Corporation Limited* 84 ATC 4642; (1984) 15 ATR 982 Beaumont J, in analysing the construction of the 'Special Conditions' governing a debenture issue by the taxpayer, said (at ATC 4659-60; ATR 1004-5):

'It is possible to imagine a case where, <u>on the true</u> <u>construction of their contract</u>, parties make provision for the payment or crediting of a special kind of premium, <u>entitlement to which springs into existence</u>, for the first <u>time at a remote future date</u>. It would be a feature of such a contract that, if it did not run its full term...the lender would have no entitlement to interest as such... Certainly, he could not claim for interest accrued due at that point of time.' (Underline added)

His Honour then concluded (at ATC 4660; ATR 1005):

'The language employed emphasises that the primary objective of the draftsman of the Special Conditions was to defer the payment or crediting of interest until redemption... In my view, consistently with his primary objective, the draftsman did not intend to disturb the ordinary position that interest accrues due on a daily basis over the period of the investment. It is significant, in this regard, first, that what was being dealt with was interest in the conventional sense and, secondly, that it was to be calculated from the date of investment.' (Underline added)

23. In *Willingale* Lord Fraser of Tullybelton (at TC 273), in distinguishing a discount from interest also indicated that interest would not always accrue daily but may accrue over specified periods:

'In my opinion there is an essential difference between interest and discount, so much so that to speak of 'earning' discount, seems to me wrong. Interest accrues from day to

- day, <u>or at other fixed intervals</u>, but discount does not.' (Emphasis added)
- 24. Interest payable under securities purchased and sold cum interest is an example of the common law rule being varied under the terms of a particular agreement.
- 25. Hence, in *Case F26* 74 ATC 132; 19 CTBR (NS) *Case 44* the No. 3 Board of Review unanimously held that the capital cost of government bonds and semi-government securities acquired by a building society was the amount paid to acquire the securities and the building society was not entitled to any portion of those outlays as expenditure on revenue account to acquire the future interest income. Mr Dempsey (Member) agreed with counsel for the taxpayer that it was not correct to say that interest on the securities accrued *de die in diem*. The interest was payable on given due dates as was the case in *Wigmore (H.M. Inspector of Taxes) v. Thomas Summerson and Sons, Limited* (1925) 9 TC 577 (*Wigmore's case*). Mr Dempsey then went on to state (supra at ATC 153; CTBR (NS) 314):
  - '... interest on these securities does not accrue "de die in diem" and is only assessable when received.'
- 26. In *Wigmore's case* (supra) the taxpayer company had been assessed under the U.K. *Income Tax Act 1918* in respect of an amount of interest deemed to have accrued on a series of 5% War (loan) Stock in the period between the last payment of interest and the date of the company's sale of the Stock cum interest, it being contended by the Inland Revenue Commissioners that the price received by the company on sale of the Stock included this accrued interest. In considering this point Rowlatt J said (supra at TC 581):

'This stock... is sold *en bloc* for a sum for principal and accrued and accruing interest; and it is not true to say in fact that in the purchase price there is necessarily to be found a sum as purchase money of the accrued interest exactly equivalent to the amount of interest which has accrued...The truth of the matter is that the seller does not receive "interest", and "interest" is the subject matter of the taxation. He receives the price of the expectancy of interest, and that is not the subject of taxation, and the whole thing, I think, really depends upon that fallacy. In truth you cannot put the case without relying on the theory that the interest accrues *de die in diem*.' (Underline added)

27. The latter part of Rowlatt's J judgment reflects an important concession made by counsel for the United Kingdom Inland Revenue that interest income under the War Stock could not be treated as

page 8 of 12

FOI status draft only - for comment

accruing *de die in diem* and apportionable in the case of a holder who held continuously from year to year.

28. The case of *The Commissioners of Inland Revenue v. Sir John Oakley* (1925) 9 TC 582 (*Oakley's case*) was heard by Rowlatt J immediately after *Wigmore's case*. The taxpayer had sold, cum interest, certain 8% Registered Notes of a limited company on 29 November 1922 which happened to be the eve of the payment of half yearly interest. However, due to a delay in the execution of the sale contract interest on the Notes accrued due and was paid to the vendor taxpayer instead of the purchaser. The interest was then duly handed to the purchaser by the vendor. In holding that the interest was not income of the taxpayer but of the purchaser, Rowlatt J acknowledged that curious results arise when accrued interest is not taken into account but nevertheless held (supra, at TC 585):

'On the 29th November, although it was the 29th November, he (the taxpayer) sold the whole thing, sold the principal and accrued interest, and the purchaser got it, and there it is, that is where the liability (for income tax) must fall, on the purchaser...' (Underline added)

- 29. Unlike ordinary interest which accrues *de die in diem*, rights to interest payable under certain interest bearing securities do not arise to their holders until the due date for payment. Vendors of such securities relinquish at the date of sale their rights to interest that would otherwise have accrued due to them during the period in which they held the security. On the other hand, purchasers of the securities 'cum interest' obtain the rights to all interest accrued since the last coupon date.
- 30. The accrued interest component is recognised in the market as a precisely quantified element in the cost of a security and therefore capable of separate calculation notwithstanding that other factors may affect the price of a security at any given time. For example, the time still to run to maturity date and the effect on the financial markets of new security issues. Nevertheless, the purchase price, including any interest accrued but unpaid at the date of acquisition of the security, is an outlay of a single indivisible sum. The purchased interest should not be treated as a deduction from, or reduction to, interest derived nor as an adjustment to the purchase price. It should also be noted that where the traditional securities provisions of the Act apply to the disposal of a security, sections 26BB and 70B make no provision for separating the accrued interest component out of the sale or purchase price when calculating the gain or loss on disposal.
- 31. Most business investors in fixed and variable interest securities calculate income for accounting purposes on a daily accruals basis. However, the full purchase price is a capital outlay and the correct

taxation treatment involving the purchase and sale of fixed interest securities is not to be determined by a taxpayer's method of accounting. This was made clear in ATC *Case F26*; CTBR *Case 44* (supra) by Mr Dubout (Chairman) when, after referring with approval to several United Kingdom cases on accrued interest including *Wigmore's case* (supra) and *Oakley's case* (supra), he concluded (supra at ATC 139; CTBR (NS) 298):

'To say that the component of accrued interest can be identified in the total capital cost of a security, however, is not to say that it can, for income tax purposes, be severed from the total cost and invested with a non-capital character. As a matter of making entries in accounts, this component can be, and in this case, has been, severed from the total. Although this may be accepted as recognised accountancy practice, I am unable to see that the capital cost of a security is other than the total amount paid for it.' (Underline added)

- 32. The authorities support the view that, where the principal and interest components of the securities are not dealt with separately, businesses that invest in fixed or variable interest securities cum interest should bring interest derived from those securities to account for tax purposes on a due and receivable basis. An example of the due and receivable approach is set out at paragraph 34 of this Ruling.
- 33. The daily accruals method is not an appropriate method for businesses to bring to account the purchased interest component of securities that are purchased and sold cum interest. It follows that the interest income should not be returned on a daily accruals basis or returned at the time of disposal of the security through an adjustment to its cost price.

### **Examples**

34. 'A' is an insurance company that invests in fixed and variable interest securities. It acquires for face value a three year \$100 fixed interest bond at issue date on 1 December 19x0 (Interest coupon at 12% per annum, payable semi-annually on 1 June and 1 December). 'B', another insurance company that also invests in such bonds as part of its business activities, purchases the bond from 'A' cum interest halfway through an interest coupon period on 1 March 19x2 for \$103 (\$3 premium representing interest being treated as having accrued since 1 December 19x1). On 1 June a \$6 interest coupon is payable on the bond

page 10 of 12

FOI status draft only - for comment

Assume further that both 'A' and 'B' have 30 June balance dates and that there have been no other market effects to the value of the bond.

The taxation accounts of 'A' should show the following amounts of income derived on a due and receivable basis:

Income Tax	<u>Income derived</u>
Year Ended	
30/6/x1	\$6.00 (25(1))
30/6/x2	\$6.00 (25(1))
30/6/x2	\$3.00 (25(1)/26BB))

'A' has an assessable gain on disposal of \$3.00 pursuant to either subsection 25(1) or section 26BB because the sale price of the bond (\$103.00) cannot be apportioned between principal and interest.

On the other hand, the taxation accounts of financial institution 'B' should show the following amounts of income derived on a due and receivable basis:

<u>Income derived</u>
\$nil
\$ 6.00 (25(1))
\$12.00 (25(1))
\$6.00 (25(1)
(\$3.00) (51(1)/70B)

'B' has an allowable deduction for loss on disposal of the bond equal to \$3.00 pursuant to subsection 51(1) or section 70B because the acquisition price of the security (\$103.00) cannot be apportioned between principal and interest.

### **Commissioner of Taxation**

#### 17 December 1992

ISSN 1039 - 0731 Price \$1.00

ATO references FOI index detail NO - reference number

BO NOR J5/186/3-2 NOR J5/190/1-1

Not previously released to the public in draft form

FOI status draft only - for comment

page 11 of 12

### subject references

- assessable income
- interest
- securities purchased cum interest
- securities sold cum interest

### legislative references

- ITAA 25(1);
- ITAA 26BB; ITAA 70B
- ITAA 159GP(1); ITAA Div. 16E
- Conveyancing Act 1919 (NSW) 144(1)

page 12 of 12

FOI status draft only - for comment

#### case references

- Case F26 74 ATC 132
  (1974) 19 CTBR (NS) 291 Case 75
- Case P52 (1964) 14 TBRD 236 11 CTBR (NS) 437 Case 75
- Australasian Catholic Assurance Co. Limited v. FC of T (1959) 100 CLR 502
- FC of T v. Australian Guarantee Corporation Limited 84 ATC 4642; (1984) 15 ATR 982
- Californian Copper Syndicate v. Harris (1904) 5 TC 159
- Chow Yoong Hong v. Choong Fah Rubber Manufactory (1961) 3 All ER 1163; (1962) AC 209
- Colonial Mutual Life Assurance Society Limited v. FC of T (1946) 73 CLR 604
- The Commissioners of Inland Revenue v. Sir John Oakley (1925) 9 TC 582
- Punjab Co-operative Bank Limited, Amritsar v. Commissioner of Income Tax, Lahore (1940) AC 1055
- In re Rogers' Trusts (1860) 62 ER 408
- The State of South Australia v. The Commonwealth of Australia 92 ATC 4066; (1992) 23 ATR 10
- Wigmore (H.M. Inspector of Taxes)
  v. Thomas Summerson and Sons,
  Limited (1925) 9 TC 577
- Willingale (H.M. Inspector of Taxes) v. International Commercial Bank Limited (1978) 52 TC 242