


TR 1999/11 - Income tax: basis of assessment of interest paid in advance and received in advance by financial institutions

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Taxation Ruling

Income tax: basis of assessment of interest paid in advance and received in advance by financial institutions

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Preamble

*The number, subject heading, **Class of person/arrangement**, **Date of effect** and **Ruling** parts of this document are a 'public ruling' for the purposes of Part IVAAA of the **Taxation Administration Act 1953** and are legally binding on the Commissioner. The remainder of the document is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling clarifies when interest received and paid in advance by a financial institution is derived as income or is allowable as a deduction for the purposes of the *Income Tax Assessment Act 1936* (the 1936 Act) and the *Income Tax Assessment Act 1997* (the 1997 Act). The Ruling proceeds on the basis that interest received is assessable under subsection 25(1) of the 1936 Act or section 6-5 of the 1997 Act, and interest paid is deductible under subsection 51(1) of the 1936 Act or section 8-1 of the 1997 Act, to taxpayers that are financial institutions.

Class of person/arrangement

2. The class of arrangements to which this Ruling applies are financial instruments and investments including:

- overdrafts, term loans, personal and other loans;
- interest bearing deposits; and
- securities issued or held by financial institutions.

3. This Ruling does not apply to 'qualifying securities' as defined in subsection 159GP(1) in Division 16E of Part III of the 1936 Act other than any prepaid 'periodic interest'. Also, this Ruling does not apply to bills of exchange, promissory notes and other commercial paper issued at a discount to which Division 16E does not apply (for example, by reason of their term being less than twelve months).

4. The class of persons to which this Ruling applies is taxpayers that fall within the restricted meaning of 'financial institution'

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contained in Taxation Ruling TR 93/27. That is, a taxpayer that principally, and in the ordinary course of its business operations, derives assessable income by lending or investing funds obtained by way of deposit or borrowing.

5. Taxpayers that fall within the restricted meaning of 'financial institution' used in this Ruling include banks, merchant banks, finance companies (including in-house finance companies), building societies, credit unions and moneylenders. Taxpayers that do not fall within the restricted meaning of 'financial institution' used in this Ruling include insurance companies (both general and life), approved deposit funds, friendly societies and superannuation funds.

6. A full explanation of the restricted meaning of 'financial institution' used in this Ruling is contained in Taxation Ruling TR 93/27.

Ruling

Interest paid in advance

7. The incurring of expenditure by a financial institution (other than 'excluded expenditure' as defined in section 82KZL of the 1936 Act), consisting of payment of an amount of interest under a loan agreement, will be subject to the operation of section 82KZM of the 1936 Act if the expenditure is incurred in return for the making available or continued making available of the loan principal over a period which exceeds 13 months and the other requirements for application of section 82KZM are met.

Interest received in advance

8. A receipt of interest paid in advance (or prepaid interest) is assessable to a financial institution under subsection 25(1) of the 1936 Act or section 6-5 of the 1997 Act in the income year in which it is received. However, where the terms of the loan agreement indicate that the practical possibility of repayment is inherent in the circumstances of the receipt, the prepaid interest should be brought to account as income, over the period to which it relates, in accordance with the terms of the agreement.

Date of effect

9. 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).

Explanations

Interest paid in advance

10. Section 82KZM, the operative provision of Subdivision H of Division 3 of Part III of the 1936 Act, modifies the operation of section 51 of the 1936 Act and section 8-1 of the 1997 Act in relation to the timing of deductions for expenditure meeting the requirements of the section.

11. The effect of section 82KZM is to evenly spread a deduction for expenditure over the income years comprising an 'eligible service period' not exceeding 10 years. The section applies where the expenditure (other than 'excluded expenditure' as defined in section 82KZL) was incurred under an agreement entered into after 25 May 1988 'in return for the doing of a thing under the agreement that is not to be wholly done within 13 months after the day on which it is incurred'.

12. The expression 'incurred in return for the doing of a thing under the agreement' identifies the type of expenditure to which section 82KZM applies. The expression is not defined in the subdivision. However, it is of broad application and embraces the provision or continued provision of financial benefits.

13. In this regard subsection 82KZL(2) clarifies the meaning of 'incurred in return for the doing of a thing under the agreement that is not to be wholly done within 13 months' as those words are used in section 82KZM. It does this by providing three examples of expenditure which are assumed to have been made in return for the doing of a thing. Specifically, paragraph 82KZL(2)(a) provides that where the expenditure incurred comprises 'the payment of loan interest or a payment of a similar kind... [the expenditure shall] be taken to be incurred in return for the making available or continued making available,... of the loan principal,... under the agreement during the period to which the payment relates'.

14. Section 82KZM applies to interest payments made under a loan where the interest payment relates to the making available or continued making available of the loan principal over a period exceeding 13 months (and the other requirements for application of the section are met).

15. For the purposes of determining the amount of the deduction allowable in each income year the Explanatory Memorandum and

subsection 82KZL(2) emphasise that the 'eligible service period' of the interest expenditure is determined by reference to the period to which the interest relates and not the term of the loan.

Interest received in advance

16. Income, when not statutorily defined, is, like profits and gains, defined by the world of affairs, particularly business (*Commissioner of Taxes (SA) v Executor Trustee And Agency Co. of South Australia Ltd (Carden's case)* (1938) 63 CLR 108). '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 realized or immediately realizable form' (*Carden's case* at page 155 per Dixon J). Gains, that is to say gross income, have 'come home' to the taxpayer when they are completely made and there is therefore neither legal nor business unsoundness in regarding them as income derived (*Arthur Murray (NSW) Pty Ltd v FCT* (1965) 114 CLR 314 at page 318).

17. It has been argued that the decision in *Arthur Murray* applies to accrue prepaid interest as income over the term of the loan. The argument proposes that interest is earned over the term of the loan and, as *Arthur Murray* holds that a receipt is not income until earned, prepaid interest becomes income over the term of the loan.

18. *Arthur Murray* concerned the receipt of fees for, and in advance of, the provision of dancing lessons. The High Court saw the issue before them as being whether, in the taxpayer's circumstances, receipt without earning made income. This was in contrast to the issue of whether earning without receipt made income in *Carden's case*. Their Honours found that 'the ultimate inquiry in either kind of case, of course, must be whether that which has taken place, be it the earning or the receipt, is enough by itself to satisfy the general understanding among practical business people of what constitutes a derivation of income' (at page 318). The characteristic of uncertainty was, in their Honour's view, pivotal to that general understanding among practical business people.

19. In *Carden's case* it was the uncertainty of the receipt of the fees earned by the taxpayer. In *Arthur Murray* it was the uncertainty of retention of the fees, should the dancing lessons for which they were paid not be given. In reference to *Carden's case*, their Honours pointed out that the uncertainty of receipt inherent in the taxpayer's earning from his medical practice was decisive in Dixon J's determination that the fees had to be received in order to become the taxpayer's income. They went on to say:

'Likewise, as it seems to us, in determining whether actual earning has to be added to receipt in order to find income, the answer must be given in the light of the

necessity for earning which is inherent in the circumstances of the receipt.

...

But those circumstances nevertheless make it surely necessary, as a matter of business good sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may in effect have to be paid back, even if only as damages, should the agreed *quid pro quo* not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it will be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company.' (at page 319)

20. In *Arthur Murray* the uncertainty of retaining the advance fees, should the dancing lessons for which they were paid not be given, was the basis for the finding that the fees were not income when they were received. It was the practical possibility of repayment of the fees in the event of the *quid pro quo* of dancing lessons not being rendered which was the inherent characteristic of the receipt itself that prevented it from having the quality of income. In other words, earning the fees by providing the dancing lessons overcame the inherent characteristic of the practical possibility of repayment and made the fees income.

21. The essence of interest is that it is referable to a principal sum. It is compensation to the lender for being kept out of the use and enjoyment of the loan principal. Furthermore, the parties to a loan may agree that interest will be paid as they see fit and independently of the repayment of the loan principal (*FC of T v The Myer Emporium Limited* (1987) 163 CLR 199 at page 218).

22. Where the parties agree that the interest will be paid in advance and the loan principal repaid on the expiry of the loan term, the prepaid interest is received in return for the lender's agreeing to make the loan principal available to the borrower for the duration of the loan. In these circumstances the prepayment is a gain completely made by the lender and there is neither legal nor business unsoundness in regarding it as income derived. Thus the prepaid interest is assessable to the lender in the year in which it is received.

23. In contrast to the situation in *Arthur Murray*, the practical possibility of repayment is not an inherent characteristic of a receipt of prepaid interest in circumstances where the lender agrees to make the loan principal available to the borrower for the duration of the loan.

The prepaid interest has, in such circumstances, been wholly earned when it is received. There is no further 'necessity for earning which is inherent in the receipt'. Whilst Cooke J in *Commissioner of Inland Revenue v National Bank of New Zealand* 77 ATC 6001 at page 6032; (1977) 7 ATR 282 at page 306 observed that 'interest is earned as money is left outstanding', it was in the context of loan agreements whereby interest accrues day by day and is payable in arrears. In this respect his Honour's observation accords with Lord Ormrod's perspective in *Willingale (Inspector of Taxes) v International Commercial Bank Ltd* [1977] 2 All ER 618 at page 628 that 'Money earns "interest" because the lender becomes legally entitled to it during the year of account'.

24. However, where the prepaid interest is not received in return for making the loan principal available for the duration of the loan, the terms of the loan agreement will influence whether the practical possibility of repayment is an inherent characteristic of the receipt. For example, the loan agreement may provide for a refund of prepaid interest in the event of early termination of the loan. In these circumstances the prepaid interest would become income of the lender over the period to which it relates in accordance with the terms of the agreement (*Case B47* 70 ATC 236; (1970) 15 CTBR (NS) 714 *Case 109*; *Case B51* 70 ATC 253; (1970) 15 CTBR (NS) 736 *Case 113*).

Commissioner of Taxation

14 July 1999

<i>Previous draft:</i> TR 92/D39	- Case B51 70 ATC 253; (1970) 15 CTBR (NS) 736 Case 113
<i>Related Rulings/Determinations:</i> TR 93/27 TR 94/25	- Arthur Murray (NSW) Pty Limited v. FC of T (1965) 114 CLR 314 - The Commissioner of Taxes (South Australia) v. Executor Trustee and Agency Co. of South Australia Limited (Carden's case) (1938) 63 CLR 108
<i>Subject references:</i> allowable deductions assessable income financial institutions prepaid interest	- Commissioner of Inland Revenue v. The National Bank of New Zealand 77 ATC 6001; (1977) 7 ATR 282 - FC of T v. The Myer Emporium Limited (1987) 163 CLR 199 - Willingale (H.M. Inspector of Taxes) v. International Commercial Bank Limited [1977] 2 All ER 618
<i>Legislative references:</i> - ITAA 1936 .25(1); 51(1); 82KZL;82KZM; 159GP(1) - ITAA 1936 Div.16E of Pt III - ITAA 1997 6-5; 8-1	
<i>Case references:</i> - Case B47 70 ATC 236; (1970) 15 CTBR(NS) 714 Case 109	

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