# *TR 2001/9 - Income tax: agency development loans*



This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

This document has changed over time. This is a consolidated version of the ruling which was published on *29 November 2006*

# Taxation Ruling
Income tax: agency development loans


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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

### Class of person/arrangement

1. This Ruling considers the taxation treatment of Agency Development Loans ('ADLs') for both life assurance companies and their agents. In particular, the Ruling explains the circumstances under which ADLs that have been made and are then forgiven or written-off:

(a) may be allowable as a deduction to life assurance companies under the provisions of the *Income Tax Assessment Act 1997* ('the 1997 Act') or the *Income Tax Assessment Act 1936* ('the 1936 Act'), specifically:

- section 8-1 of the 1997 Act;
- subsection 51(1) of the 1936 Act;
- sections 111A and 111AA of the 1936 Act;
- subsections 111AC(2) and 111AD(3) of the 1936 Act;
- sections 113 and 113A of the 1936 Act;
- subsection 25-35(1) of the 1997 Act; and
- subsection 63(1) of the 1936 Act

(see paragraphs 11-29 and 82-122 below);

(b) may be allowable as a loss to a life assurance company upon the disposal of a "traditional security" within the

meaning of section 70B of the 1936 Act - see paragraphs 30-31 below;

(c) may be allowable as a capital loss to a life assurance company under the provisions of the 1997 Act or the 1936 Act, specifically:

- Part 3-1 of the 1997 Act; and
- Part IIIA of the 1936 Act

(see paragraphs 33-45 and 126-139 below);

(d) may be assessable to life assurance agents, who are the recipients of such loans, under subsection 6-5(1) of the 1997 Act (subsection 25(1) of the 1936 Act), paragraph 26(e) of the 1936 Act, or Part 3-1 of the 1997 Act (Part IIIA of the 1936 Act) - see paragraphs 46-63 and 140-166 below;

(e) may have the effect of generating a net forgiven amount to be used to reduce certain losses, deductions and asset cost bases of an agent under Schedule 2C (Division 245) of the 1936 Act - see paragraphs 64-74 and 167-188 below.

2. This Ruling does not consider the taxation consequences arising from ADLs for the purposes of:

- the *Fringe Benefits Tax Assessment Act 1986*; or
- section 21A of the 1936 Act.

3. These aspects of ADLs were the subject of Taxation Ruling TR 93/38 titled 'Taxation consequences of insurance companies providing interest free or low interest loans to insurance agents or their employees'.

**Cross reference of provisions**

4. Within this Ruling, reference is made to both the 1997 Act and the 1936 Act. Where the 1997 Act contains a provision of the 1936 Act rewritten in a different form of words in order to use a simpler style, the idea expressed in the provision is not to be taken as different just because a different form of words is used (refer section 1-3 of the 1997 Act). The following table cross-references the sections of the 1997 Act referred to in this Ruling to the corresponding sections of the 1936 Act.

| 1997 Act | 1936 Act |
|---|---|
| subsection 6-5(1) | subsection 25(1) |
| section 8-1 | subsection 51(1) |
| paragraph 25-35(1)(a) | paragraph 63(1)(a) |
| paragraph 25-35(1)(b) | paragraph 63(1)(b) |
| subsection 104-10(1) | subsection 160L(1) |
| subsection 104-25 (1) | paragraph 160M(3)(b) |
| subsection 104-25(3) | paragraph 160Z(1)(b) |
| section 104-35 | subsection 160M(6) |
| section 108-5 | subparagraph 160A(a)(ii) |
| section 110-25 | subsection 160ZH(1) |
| subsection 116-30(1) | subsection 160ZD(2) |
| paragraph 116-30(2)(b) | paragraph 160ZD(2)(c) |
| subsection 116-30(3A) | subsection 160ZD(2A) |
| paragraph 118-20(1)(a) | subsection 160ZA(4) |
| paragraph 118-20(2)(a) | paragraph 160ZA(4)(d) |
| Part 3-1 | Part IIIA |

# Ruling

## Definitions

***Agency development loans (ADLs) (see paragraphs 76 - 77)***

5. Agency development loans ("ADLs") have been made by some life assurance companies to their agents. The amount of an ADL that an agent will be entitled to have advanced to them will usually be determined by a formula linked to sales and may be reviewed periodically. Based on this formula, additional amounts of ADL monies may be advanced by the life assurance company to the agent from time to time.

***Performance based ADLs (see paragraphs 78 – 79)***

6. Some ADL agreements entered into between life assurance companies and their agents envisage in their terms a forgiveness (in part, or in full) of the ADL in consideration for the achievement by the agent of specified performance standards, including sales targets, over

the course of the agreement. These ADLs are referred to in this Ruling as "performance based ADLs".

7. In this Ruling, "forgiveness" is regarded as meaning the giving up of any claim for restitution or remedy in respect of a debt, so as to extinguish the debtor's liability in a legally effective manner.

***Conventional ADLs (see paragraph 80)***

8. Other ADLs do not make provision for loan forgiveness in consideration for the achievement of performance standards. These ADLs are referred to as "conventional ADLs" in this Ruling.

9. A life assurance company may enter into a conventional ADL with an agent and subsequently enter into a further agreement with the agent which provides for the future forgiveness of the original amount and/or any further amounts, subject to the agent meeting specified performance standards. This Ruling treats these loans as having become performance based ADLs when the company and the agent enter into the new agreement. Amounts subsequently forgiven in consideration for the achievement of performance standards will thus be treated as having been forgiven under a performance based ADL.

***Distinction between forgiveness and write-off (see paragraph 81)***

10. In this Ruling, a distinction is made between:

(a) the forgiveness of an ADL; and

(b) the writing off of an ADL.

This distinction is made because the purpose of each of these actions is different and therefore different tax results follow. Whilst forgiveness is the giving up of a claim for remedy in respect of a debt, write off is merely an accounting recognition indicating that a creditor has treated a debt as bad.

**Deductibility to life assurance companies under section 8-1 (subsection 51(1))**

***Deductibility to life assurance companies under section 8-1: the loaned amount***

11. As the life assurance company will expect repayment of the loaned sum, no relevant loss or outgoing is incurred by the company at the time of making the ADL. At this time, a loss is a mere possibility. Accordingly, the amount loaned under either a conventional or a performance based ADL is not deductible to the life assurance company at the time of making the loan.

***Deductibility to life assurance companies under section 8-1: performance based ADLs which are forgiven (see paragraphs 82 - 85)***

12. The nexus between the performance of the agent and the forgiveness of a performance based ADL operates to stamp the forgiven amount with a remunerative character. Consequently the forgiveness is properly regarded as being on revenue account. Hence, to the extent that the forgiven amount is referable to the gaining or producing of assessable income and is not capital in nature, it will be deductible under section 8-1.

13. Superannuation premiums and the investment component of relevant life assurance policies were excluded from assessable income by virtue of subsection 111(1) of the 1936 Act that operated until 30 June 2000. Thus, any proportion of a performance based ADL that related to the gaining or producing of non-assessable premiums will not be deductible under section 8-1 for the period to 30 June 2000 in the absence of specific provisions allowing deductibility (see the discussion relating to the operation of sections 111A, 111AA, 111AC and 111AD below). The *New Business Tax System (Miscellaneous) Act (No. 2) 2000* repealed subsection 111(1) and sections 111AC and 111AD with effect from 30 June 2000 (sections 111A and 111AA of the 1936 Act were repealed in 1994) and introduced Division 320 into the 1997 Act. Section 320-15 now makes life assurance premiums statutory income. The effect of Division 320 and of the repealed provisions is discussed at paragraphs 18-25 and paragraph 28 below.

***Deductibility to life assurance companies under section 8-1: performance based ADLs which are written off (see paragraphs 86 - 90)***

14. If a life assurance company writes off a performance based ADL as bad, the written off amount retains its character as a loan. Generally, mere write off of a debt will not give rise to a deduction as write off is merely an accounting recognition that a debt is unlikely to be recovered. A deduction will arise to the life assurance company only where the debt becomes irrecoverable (for example, recovery of the debt is commercially impossible). No additional deduction would be allowable if the life assurance company subsequently forgives the loan.

***Deductibility to life assurance companies under section 8-1: conventional ADLs which are forgiven (see paragraphs 91 – 95)***

15. Conventional ADLs may be forgiven by a life assurance company instead of being called in. If the forgiveness:

- occurs as a result of the agent meeting specified performance standards; and
- is pursuant to a further agreement entered into between the agent and the life assurance company subsequent to the entering of the original loan agreement,

the loan is treated as having taken on the characteristics of a performance based ADL from the time the new agreement is entered into. In this case, paragraphs 12-13 of this ruling regarding performance based ADLs will apply.

16. If no further agreement has been entered into between the life assurance company and the agent to introduce the concept of forgiveness of debt for meeting specified performance standards, the ADL retains its character as a conventional ADL. In this situation, the amount of the ADL forgiven will not be deductible under section 8-1. We consider advances made under a conventional ADL to be capital amounts directed towards the preservation and strengthening of the life assurance company's profit-yielding structure. The structure or organisation of the life assurance company as a business entity is enhanced through the establishment of a sales network comprised of high performing agents.

***Deductibility to life assurance companies under section 8-1: conventional ADLs which are written off (see paragraphs 96 – 97)***

17. If the life assurance company writes off a conventional ADL as bad, the written off amount retains its character as an advance which is capital in nature and will not be deductible under section 8-1.

**Deductibility to life assurance companies under specific provisions**

***Deductibility to life assurance companies under subsection 51(1): former sections 111A and 111AA (see paragraphs 98 – 101)***

18. Former section 111A of the 1936 Act applies to the period between 1 July 1988 and 31 December 1993. Former section 111AA applies to the period between 1 January 1990 and 31 December 1993. These sections operated to deem superannuation premiums and the investment component of relevant life assurance policies to be assessable income for the purposes of determining allowable deductions under subsection 51(1).

19. To the extent that the forgiven amount of a performance based ADL is properly referable to the earning of superannuation premiums or the investment component of relevant life assurance policies during the applicable periods, the amount forgiven will be deductible under subsection 51(1) via the mechanism of sections 111A and 111AA. Forgiven amounts are regarded as deductions referable to direct costs of obtaining exempt Australian life assurance premiums (see paragraph 27 of Taxation Ruling TR 95/28).

20. Written off amounts of performance based ADLs referable to superannuation premiums or the investment component of relevant life assurance policies are deductible under section 51 via the mechanism of sections 111A and 111AA when the conditions set out at paragraph 14 above are met.

21. Written off or forgiven amounts of conventional ADLs are considered to be capital amounts. Accordingly, they are not deductible irrespective of the operation of sections 111A and 111AA (refer to the negative limb of subsection 51(1) which excludes deductions for amounts of capital or of a capital nature).

***Deductibility to life assurance companies under specific provisions: sections 111AC and 111AD (see paragraphs 102 – 108)***

22. Sections 111AC and 111AD of the 1936 Act replaced sections 111A and 111AA as of 1 January 1994 and operated until 30 June 2000.

23. The forgiven amount of performance based ADLs will be deductible under paragraphs 111AC(2)(e) or 111AD(3)(e) during the period these provisions operated, to the extent that the amount is incurred for the purposes specified in those paragraphs. In determining the deductibility of the forgiven amount under these provisions, it will be essential to identify the classes of business written by the agent on behalf of the life assurance company. Where the forgiven amount of the ADL represents mixed purpose expenditure, it can be pro-rated, on a reasonable basis, between paragraphs 111AC(2)(e), 111AD(3)(e) and subsection 51(1) of the 1936 Act, and section 8-1 of the 1997 Act, depending upon the composition of the business written by the agent. Any residual amount not deductible under these provisions may give rise to a capital loss under Part 3-1 of the 1997 Act or Part IIIA of the 1936 Act (see paragraphs 33-42 below).

24. Written off or forgiven amounts of conventional based ADLs are of a capital nature and, therefore, are not deductible under sections 111AC or 111AD (refer subsections 111AC(4) and 111AD(5)).

25. Written off amounts of performance based ADLs are of a revenue nature and, therefore, are deductible under paragraphs

111AC(2)(e) and/or 111AD(3)(e) to the extent they are incurred for the purposes specified in those paragraphs and, additionally, they meet the conditions set out at paragraph 14 above.

***Deductibility to life assurance companies under specific provisions: sections 113 and 113A – general management expenses (see paragraphs 109 – 110)***

26. Sections 113 and 113A of the 1936 Act operated up to 30 June 2000. Expenditure is only deductible under section 113 or 113A if it is incurred in the managing, as distinct from the carrying on, of the business. Accordingly, neither performance based nor conventional ADLs fall within the meaning of general management expenses in sections 113 or 113A.

27. This means that no deduction will be allowable under either sections 113 or 113A for performance based or conventional ADLs forgiven or written off.

***Deductibility to life assurance companies under specific provisions: Division 320***

28. The provisions in Division 320 of the 1997 Act operate from 1 July 2000. This Division provides a new basis for taxing life assurance companies, replacing Divisions 8 and 8A of the 1936 Act. Division 320 contains special rules for working out the taxable income of life assurance companies and, in particular, provides for deductions for certain claims. However, the deductibility for write off or forgiveness of performance based or conventional ADLs continues to be considered under the rules referred to elsewhere in this ruling and does not fall for separate consideration within the special rules set out in Division 320.

***Deductibility to life assurance companies under specific provisions: subsection 25-35(1) of the 1997 Act (subsection 63(1) of the 1936 Act) – the bad debt provisions (see paragraphs 111 – 122)***

29. Life assurance companies are considered not to carry on a business of moneylending to their agents for the purposes of paragraph 25-35(1)(b) of the 1997 Act (paragraph 63(1)(b) of the 1936 Act). Therefore, written off amounts are not deductible under either of these provisions.

**Section 70B – traditional securities**

30. The forgiveness or write off of an ADL is not a disposal for the purposes of section 70B. Therefore, no deduction is allowable

under this section for either performance based or conventional ADLs which are forgiven or written off.

31. After 1 July 1992, subsection 70B(5) further clarified this position by deeming no disposal to have occurred by the forgiveness of a debt.

### In which year can a deduction be claimed? *(see paragraphs 123 - 125)*

32. An amount forgiven under a performance based ADL is not deductible under section 8-1 of the 1997 Act or subsection 51(1), or sections 111AC or 111AD of the 1936 Act until the year of income in which forgiveness actually occurs. An amount written off under a performance based ADL is not deductible until the year of income in which the conditions set out at paragraph 14 of this Ruling are satisfied.

## Capital losses arising from ADLs

### *Capital losses arising from ADLs: performance based and conventional ADLs which are forgiven (see paragraphs 126 – 136)*

33. The amount of the debt referable to an ADL will be an asset of the life assurance company as a creditor under section 108-5 of the 1997 Act (subparagraph 160A(a)(ii) of the 1936 Act).

34. The forgiveness of a traditional security will not constitute a disposal within the meaning of section 26BB (refer Taxation Ruling TR 96/14). Therefore, the traditional security exemption in subsection 160ZB(6) (applicable to disposals or redemptions from 30 June 1989 to 30 June 1992) will not apply to the forgiveness of an ADL.

35. An asset which relates to the complying superannuation business of the life assurance company as at 30 June 1988 is deemed to have been acquired on 30 June 1988 for the purposes of Parts 3-1 and 3-3 of the 1997 Act (or Part IIIA of the 1936 Act). Accordingly, there may be capital gains or losses under Part 3-1 (or Part IIIA) in respect of the disposal of ADLs, even though the ADLs were acquired before 20 September 1985 and would not otherwise be subject to the CGT provisions.

36. The reduced cost base of a debt will not include an amount to the extent that it has already been deducted or is deductible: subsection 110-55(4) of the 1997 Act. Consequently, any capital loss upon disposal of a debt arising from an ADL must be adjusted to reflect the extent to which, if any, the forgiven amount of the debt has already been claimed as a deduction under section 8-1 of the 1997

Act, subsection 51(1), sections 111AC or 111AD of the 1936 Act, or any other relevant provisions.

37. Any legally enforceable forgiveness of a debt will be sufficient to constitute CGT event C2 under subsection 104-25(1) of the 1997 Act (paragraph 160M(3)(b) of the 1936 Act). This is the case regardless of whether some or all of the debt has previously been written off.

38. Whether a capital gain or loss occurs on the extinguishment of a life assurance company's debt will depend upon the capital proceeds (consideration) received, and the cost base of the debt. If the life assurance company receives no consideration for the extinguishment of the debt arising under an ADL after 15 August 1989, it will be taken to have received an amount equal to the market value of the debt at the time of disposal: subsection 116-30(1) of the 1997 Act (paragraph 160ZD(2)(a) and subsection 160ZD(2A) of the 1936 Act).

39. If the extinguishment occurred before 16 August 1989, there will be no deemed disposal at market value: subsection 160ZD(2) of the 1936 Act.

40. The life assurance company would also be taken to have received market value on the extinguishment, after 15 August 1989, of the debt when the consideration is less than the market value of the debt: paragraph 116-30(2)(b) of the 1997 Act (paragraph 160ZD(2)(c) of the 1936 Act).

41. The market value of the debt at the time of its disposal must be calculated as though the debt was not extinguished and was never intended to be: subsection 116-30(3A) of the 1997 Act (subsection 160ZD(2A) of the 1936 Act). If the debt is released or cancelled because it is worthless, then the market value will be nil, despite subsection 116-30(3A) of the 1997 Act (subsection 160ZD(2A) of the 1936 Act), as the disposal of itself will not affect the market value of the debt.

42. The capital loss incurred by the life assurance company will be equal to the reduced cost base of the debt, less the capital proceeds (consideration) received: subsection 104-25(3) of the 1997 Act (paragraph 160Z(1)(b) of the 1936 Act).

### *Capital losses arising from ADLs: performance based and conventional ADLs which are written off (see paragraphs 137 – 139)*

43. The analysis in paragraphs 33-42 above regarding capital losses arising from the forgiveness of performance based and conventional ADLs is equally applicable to the writing off of performance based and conventional ADLs. However, the mere action of writing off will not be sufficient to constitute a CGT event

under the 1997 Act, nor will it constitute a disposal under the 1936 Act. It will therefore be necessary for the life assurance company to ensure that the ADL debt has been extinguished before a capital loss will be available.

44. As the write off of a traditional security will not constitute a disposal within the meaning of section 26BB, the traditional security exemption in subsection 160ZB(6) (see paragraph 34 above) will have no application to the write off of an ADL.

45. The market value of the debt will be the greater of the excess of expected recoverable funds over expected recovery expenses, or nil. If the debt is written off and subsequently released, cancelled or forgiven because it is worthless, then the market value will be nil, despite subsection 116-30(3A) of the 1997 Act (subsection 160ZD(2A) of the 1936 Act), as the disposal of itself is not considered to affect the market value.

## Assessment of agents

### *Assessment of agents: performance based ADLs which are forgiven (see paragraphs 140 – 151)*

46. Amounts of performance based ADLs which are forgiven by a life assurance company upon the agent meeting specified performance standards will be assessable income of the agent.

47. The amounts forgiven are received in consideration of the achievement of performance targets and as such are in the nature of remuneration for services rendered. Therefore, the amounts will be assessable under subsection 6-5(1) of the 1997 Act (subsection 25(1) of the 1936 Act) or paragraph 26(e) of the 1936 Act.

48. Alternatively, the forgiven amounts represent gross earnings or proceeds received from transactions entered into in the ordinary course of the agent's business.

49. Where the amounts forgiven represent a profit or gain, the amount may instead be characterised as income derived by the agent from a business operation or commercial transaction entered into with the purpose or intention of making a gain. In such circumstances, the forgiven amount will be assessable under subsection 6-5(1).

50. The amounts forgiven will be derived as income in the year of income in which the performance standards specified in the ADL agreement are met.

51. It will be a question of fact whether or not the forgiven amount of an ADL represents consideration for the grant of a restrictive covenant. We consider that the forgiven amount is received in consideration for the achievement of performance targets and has no

relevant connection with any restrictive covenant provided by the agent.

52. However, if it can be established that, in substance, all or part of the forgiven amount represents capital proceeds received in respect of the grant of a restrictive covenant, forgiveness of the debt may constitute CGT event D1 (refer Taxation Ruling TR 95/3).

*Performance based ADLs forgiven for reasons extraneous to the rendering of services (see paragraphs 152 – 154)*

53. In the unlikely event that a performance based ADL is forgiven by a life assurance company for reasons other than provision of past or future services by the agent, the forgiven amount will not be assessable income to the agent under subsection 6-5(1) of the 1997 Act or paragraph 26(e) of the 1936 Act.

54. However, in the circumstances described at paragraph 53, the forgiven amount will be subject to the commercial debt forgiveness provisions in Schedule 2C of the 1936 Act (see paragraphs 64-74 below).

***Assessment of agents: performance based ADLs which are written off (see paragraphs 156 – 158)***

55. If a performance based ADL is written off by a life assurance company, the written off amount will retain the character of a loan amount in the hands of the agent. Accordingly, the written off amount will not constitute assessable income of the agent unless that writing off can be objectively seen as an arrangement that is in the nature of debt forgiveness. In such a case, paragraphs 46-52 of this ruling relating to the derivation by agents of assessable income through debt forgiveness will apply.

56. Where retention by the agent of the written off amount is unrelated to the rendering of services, the written off amount will not be assessable under paragraph 26(e).

***Assessment of agents: conventional ADLs which are forgiven (see paragraphs 159 – 163)***

57. Where a conventional ADL is forgiven in recognition of past services rendered by the agent, for example, attaining a high level of sales, the forgiven amount is a reward for service and will be assessable under subsection 6-5(1) of the 1997 Act or, alternatively, paragraph 26(e) of the 1936 Act.

58. If a further agreement is entered into, subsequent to the creation of the conventional ADL, that provides for future forgiveness

of amounts under the original loan agreement subject to the agent meeting specified performance standards, the conventional ADL becomes a performance based ADL. Accordingly, any forgiven amounts will be assessable for the reasons stated in paragraphs 46-52 above.

59. In the unlikely event that a conventional ADL is forgiven by a life assurance company for reasons other than the provision of past or future services by the agent, the amount will not be assessable income of the agent under subsection 6-5(1) of the 1997 Act or paragraph 26(e) of the 1936 Act.

***Assessment of agents: conventional ADLs which are written off (see paragraph 164)***

60. If a conventional ADL is written off by a life assurance company for reasons other than the rendering of services, the written off amount will retain the character of a loan amount in the hands of the agent. Accordingly, the written off amount will not constitute assessable income of the agent under subsection 6-5(1) of the 1997 Act.

61. Paragraph 26(e) of the 1936 Act will not apply to the written off amount.

***Application of the capital gains tax provisions (see paragraphs 165 - 166)***

62. There are no CGT consequences arising from the receipt of ADL money by the agent, as loan monies in the hands of a debtor are not considered to be a CGT asset.

63. To the extent that forgiveness of a performance based ADL gives rise to the derivation of ordinary income by the agent, any capital gain accruing to the agent from forgiveness will be reduced to zero pursuant to paragraph 118-20(2)(a) of the 1997 Act (subsection 160ZA(4) of the 1936 Act).

**Division 245 (Schedule 2C) - forgiveness of commercial debts *(see paragraphs 167 – 188)***

64. Division 245 of the 1936 Act (Schedule 2C) will apply to the forgiven amount of ADLs where such amounts are not included in the assessable income of the agent: subsection 245-15(3). Further, only ADLs which are forgiven will attract the operation of Schedule 2C: subsection 245-10(1).

65. In order for an ADL to fall within the definition of debt in subsection 245-15(1), the debt must be "commercial": subsection

245-10(1). A debt is only commercial if interest paid on it by the debtor is, ignoring the exemption provisions, deductible to the debtor, or would be if interest were payable: section 245-25. Thus, Schedule 2C will not apply unless the agent is using the ADL moneys for a purpose which would give rise to a deduction for any interest that is or would be payable.

66. A commercial debt is forgiven if the debtor's obligation to pay the debt is released or waived or otherwise extinguished: subsection 245-35(1). Mere write-off does not amount to extinguishment of the loan for the purposes of Schedule 2C. The act of the life assurance company in releasing the agent from liability to pay the debt will constitute a forgiveness of debt for the purposes of Schedule 2C: subsection 245-35(1).

67. Forgiveness will occur at the time at which the life assurance company releases, waives, or otherwise extinguishes the agent's liability to repay the debt. A debt that has previously been written off may be extinguished subsequently. In this case, the forgiveness occurs at the time the debt is extinguished. The forgiveness would not occur under an agreement or arrangement under which the debtor's obligation to pay is to cease at a particular future time: see paragraphs 245-35(3)(a) and (b); therefore, subsection 245-35(3) will not operate to deem the time of forgiveness to be when the agreement or arrangement is entered into.

68. Division 245 requires the calculation of the gross forgiven amount of the debt in accordance with Subdivision 245-C, and the net forgiven amount of the debt in accordance with Subdivision 245-D. This involves a four-step process.

69. Firstly, the "notional value" of the debt is determined. This will be the lesser of the "first applicable amount" and the "second applicable amount" of the debt under subsection 245-55(1). In the case of ADLs, the notional value of the debt will generally be equal to the amount of the ADL forgiven.

70. Secondly, the consideration in respect of the forgiveness of the debt must be calculated under section 245-65. An ADL is not a "moneylending debt" for the purposes of subsection 245-245(1). Accordingly, the "consideration" will be the amounts which the agent has paid or is required to pay as a result of the forgiveness of the ADL: subparagraph 245-65(1)(a)(i).

71. Where the arrangement for the forgiveness of the debt requires payment to be made, but there is no consideration given by the agent to the life assurance company, the agent will be deemed to have paid consideration equal to the market value of the debt at the time of forgiveness under paragraph 245-65(2)(a). This provision does not apply unless the arrangement requires payment to be made as consideration for the forgiveness.

72. Thirdly, the gross forgiven amount must be determined. As no consideration is paid or deemed to be paid by the agent to the life assurance company upon forgiveness of the ADL, the gross forgiven amount of the debt will be equal to the notional value of the debt at the time of forgiveness (subsection 245-75(1)), and the gross forgiven amount will equal either the first applicable amount or the second applicable amount.

73. Finally, under subsection 245-85(1), the gross forgiven amount is reduced by the three reduction factors, which would otherwise cause a potential increase in the income tax liability of the agent as a result of the forgiveness.

74. Where there is no interest payable on the ADL, and forgiveness does not lead to a reduction in the cost base of any of the assets held by the agent, the gross forgiven amount will equal both the net forgiven amount (paragraph 245-85(2)(a)) and the amount of the debt forgiven.

# Date of effect

75. 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

**Background information (*see paragraph 5)***

76. ADLs are made by some life assurance companies to their agents. The amount of an ADL will usually be determined by a formula linked to sales and may be reviewed periodically. Based on this formula, additional amounts of ADL monies may be advanced by the life assurance company from time to time.

77. Agents will usually qualify for an ADL on past sales performance. However, some life assurance companies have used ADLs to recruit high-performing agents from rival companies. The duration of ADLs varies but five to ten years appears to be an average term. ADLs may be called in at any time should specified events occur, such as the agent leaving or the agency agreement being cancelled by the life assurance company.

***Performance based agency development loans (see paragraphs 6 - 7)***

78. Performance based ADLs provide for forgiveness of all or part of the loaned sum in consideration of achievement by the agent of specified performance standards, incorporating sales targets, over a period of time. These standards are typically set out in the ADL agreement or schedules to the agreement.

79. In this Ruling, "forgiveness" is regarded as meaning "the giving up of any claim to restitution or remedy" in respect of the liability of a debtor: refer *Hemsworth v. Hemsworth* [1947] VLR 292 at 303. In order to achieve a legally effective extinguishment of the debtor's liability, the forgiveness must be for valuable consideration or under seal: *Commissioner of Stamp Duties (NSW) v. Bone & Ors* (1976) 9 ALR 11 at 16.

***Conventional agency development loans (see paragraphs 8 – 9)***

80. Conventional ADLs do not provide for the forgiveness of the loan in consideration of achievement of specified performance standards. The agents as parties to conventional ADL agreements have contractually bound themselves to repay the loaned amount in full to the life assurance company.

***Distinction between forgiveness and write-off (see paragraph 10)***

81. In this Ruling, a distinction is made between:

(a) the forgiveness of an ADL; and

(b) the writing off of an ADL.

This distinction is made because the purpose of each of these actions is different and therefore different tax results follow. Whilst forgiveness is the giving up of a claim for remedy in respect of a debt, write off is merely an accounting recognition indicating that a creditor has treated a debt as bad: see *Case 33* (1941) 10 TBRD 101 at 103; Taxation Ruling TR 92/18 at paragraphs 34-35.

**Deductibility to life assurance companies under section 8-1 (subsection 51(1))**

***Deductibility to life assurance company under section 8-1: performance based ADLs which are forgiven (see paragraphs 12 - 13)***

82. Performance based ADLs include provision for forgiveness upon the achievement by the agent of specified performance standards. The nexus between performance of the agent and the forgiveness of the ADL operates to stamp the forgiven amount with a

remunerative character. Consequently, the loss or outgoing arising from forgiveness is properly regarded as being on revenue account. Hence, to the extent that forgiven amounts are referable to the gaining or producing of assessable income, they will be deductible under either paragraph 8-1(1)(a) or (b).

83. Subsection 111(1) of the 1936 Act, which operated from 1 July 1988 to 30 June 2000, provided that the assessable income of a life assurance company did not include premiums received in respect of life assurance policies other than specified roll-over amounts. Consequently, during the above period, that proportion of the forgiven amount of an ADL which was referable to the derivation of such premiums was not deductible under section 8-1. Deductions that may be allowable under the former sections 111A, 111AA, 111AC and 111AD of the 1936 Act for expenditure incurred in obtaining superannuation premiums, RSA contributions, and the investment component of relevant life assurance premiums, are considered at paragraphs 98-108 below. The *New Business Tax System (Miscellaneous) Act (No. 2) 2000* repealed subsection 111(1) and sections 111AC and 111AD from 30 June 2000 (sections 111A and 111AA of the 1936 Act had been repealed in 1994) and introduced Division 320 into the 1997 Act. Section 320-15 now makes life assurance premiums statutory income. The effect of Division 320 is discussed above at paragraph 28.

84. We consider that authority for the deductibility of the forgiven amount of a performance based ADL may be derived from *BP Australia Ltd v. FC of T* (1965) 112 CLR 386; 14 ATD 1 ("the *BP case*"). In the *BP case*, the Privy Council allowed the company a deduction for amounts paid to service station proprietors directed to the creation of a tied network of service stations. The payments were calculated by reference to expected sales by the service stations. The Privy Council found that the real object was not the tied network but the orders that would flow from it. The advantage sought was the promotion of sales by up to date marketing methods which had become necessary. It was held that the payments were from circulating capital and therefore deductible under subsection 51(1) of the 1936 Act (now section 8-1 of the 1997 Act).

85. In light of the *BP case*, we recognise that, as performance based ADLs are ordinarily only forgiven upon the meeting of specified performance standards by the agent, forgiven amounts can be regarded as analogous to circulating capital. The sums forgiven are justified and reimbursed by virtue of that fact that they come back to the life assurance company through increased sales. The forgiveness is made in the expectation that the forgiven amount has been or will be recouped out of profits made from the sale of the life assurance company's products. The nexus between the extinguishment of the agent's liability and the earning of income by the life assurance

company renders the forgiven amount part of the "continuous and recurrent struggle" to sell insurance products: see the *BP case* at CLR 405.

***Deductibility to life assurance company under section 8-1: performance based ADLs which are written off (see paragraph 14)***

86. The situation may arise where an agent does not meet their specified sales targets and the life assurance company calls in the loan. Where the life assurance company decides that the loaned sum has become irrecoverable, for example because recovery is commercially impossible, the life insurance company is entitled to a deduction for the amount of the irrecoverable loan. Professor Parsons explained:[1]

> A principle that the Assessment Act is concerned only with realised gains and losses, unless there is an express exception, would be generally accepted. It is suggested that a receivable is realised when it is disposed of, when payment is received, when there is a receipt by the creditor which will discharge the debtor, **or when the debt becomes irrecoverable – the debtor being bankrupt, or recovery becoming impossible**. (Emphasis added)

87. By contrast, we do not consider the amount of a performance based ADL that is merely written off is deductible under section 8-1.

88. The write off of a performance based ADL may be distinguished from the grants in the *BP case* because the written off amount retains its character as a loan. The central feature of a loan transaction is that the parties intend that the moneys lent be repaid: *Richard Walter Pty Ltd v. FC of T* (1995) 31 ATR 95 at 108; 95 ATC 4440 at 4450; *Ferguson v. O'Neill* [1943] VLR 30 at 32. At the time of making the loan, the life assurance company makes no commitment to providing a grant or outright payment to the agent.

89. The situation is also distinguishable from the arrangements considered by the Privy Council in *Mobil Oil Australia Ltd v. FC of T* (1965) 112 CLR 407 ("the *Mobil Oil case*"). There, the relevant agreement provided for monthly payments to petrol retailers which were made by way of advances which ceased to be repayable upon the satisfaction of certain covenants. It was held that these amounts were, in effect, "advance payments" of a lump sum intended as consideration for benefits provided to the taxpayer under the agreement. By contrast, the money provided to an agent under a performance based ADL is not an "advance payment", but

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[1] Parsons RW, *Income Taxation in Australia*, The Law Book Company Ltd, 1985 at para 6.319.

unequivocally a loan which only ceases to be repayable in certain, limited circumstances.

*Alternative view*

90. The alternative view is that the amount of a performance based ADL that is merely written off (and has not, as Professor Parsons put it, become commercially impossible to recover) is to be treated in the same manner as an amount that has been forgiven. Under this view, the amounts advanced to agents under an ADL are "put out in order to gain assessable income": refer *AGC (Advances) Ltd v. FC of T* (1975) 5 ATR 243, 75 ATC 4057, per Barwick CJ at ATR 253, ATC 4059. To come within section 8-1, it is both sufficient and necessary that the occasion for the loss or outgoing should be found in whatever is productive of the assessable income: *Ronpibon Tin NL v. FC of T* (1949) 78 CLR 47 at 57; *AGC (Advances)* per Mason J at ATR 260, ATC 4070. However, this alternative view is not as compelling as the view set out at paragraphs 86 to 89 above. We therefore do not accept that a deduction is available for the amount of the loan that is written off.

***Deductibility to life assurance company under section 8-1: conventional ADLs which are forgiven (see paragraphs 15 – 16)***

91. Conventional ADLs are sometimes varied to become performance based ADLs by entering a further agreement subsequent to the entering of the original loan which provides for the future forgiveness of amounts upon the meeting of certain specified performance targets by the agent. If this occurs, the ADLs are considered to have become performance based ADLs upon the entering into of the further agreement and the above analysis in paragraphs 82-85 will apply.

92. Forgiveness of an amount of a conventional ADL may also occur in recognition of past services of the agent, rather than in recognition of the agent having met specified performance targets that are included in an agreement (or a further agreement) with the life assurance company. Where the forgiveness is in recognition of past services of the agent, we consider that the agreement remains a conventional ADL and that the loss or outgoing referable to the forgiven amounts would not be deductible under section 8-1 as:

(a) there may be an insufficient nexus between the derivation of future gain to render the forgiven amount deductible: refer *Union Trustee Co. of Australia Ltd v. FC of T* (1935) 53 CLR 263 per Rich J at 269; and

(b) in any case, the forgiveness takes place on capital account.

93. The forgiveness can be distinguished from the arrangements considered in the *BP case* and the *Mobil Oil case* on two bases:

(a) In both cases there was an arrangement to pay or to repay the expenses of the proprietors whose service stations were being upgraded, whereas with conventional ADLs (unlike performance based ADLs) there is no such arrangement.

(b) In both those cases, the amount of the relevant payments was based upon the estimated gallonage that the retailers were expected to sell over the relevant period. The outgoings were in the nature of circulating capital, as the expenditure was intended to be directly recouped from profits made from selling increased quantities of petrol. Whilst the life assurance company likewise expects to receive repayment of the principal sum advanced under a conventional ADL, unlike the oil company cases, the amount of the conventional ADL is not directly related to any identified increased earnings to the life assurance company flowing from the payment.

94. Where forgiveness of an amount of a conventional ADL occurs in recognition of past services of the agent, the life assurance company may be entitled to a capital loss upon forgiveness (see paragraphs 126–136 below).

*Alternative view*

95. The alternative view is that forgiveness of a conventional ADL represents payment to the agent for services rendered, i.e., a form of remuneration, so that the necessary nexus is established and the payment is on revenue account. An amount forgiven in respect of services rendered is analogous to amounts forgiven for the achievement of performance standards, i.e., is directly or indirectly connected to increasing sales: see *Maryborough Newspaper Company Ltd v. FC of T* (1929) 43 CLR 450. We do not accept this alternative view. For the reasons discussed in paragraphs 91 to 94 above, we consider the forgiveness of a conventional ADL to be on capital account.

***Deductibility to life assurance company under section 8-1: conventional ADLs which are written off (see paragraph 17)***

96. We consider that the written off amount of a conventional ADL is not deductible under section 8-1 as the written off amount retains its character as an advance which is capital in nature.

*Alternative view*

97. The alternative view is that the written off amount of a conventional ADL is deductible under section 8-1. Arguments similar to those in paragraph 90 above can be advanced in favour of this alternative view. These arguments are not as compelling as they are in the context of performance based ADLs as conventional ADLs are intended to be repayable and are therefore not as easily related to the income earning process of the life assurance company. We therefore do not accept that the written off amount of a conventional ADL is deductible under section 8-1.

**Deductibility to life assurance companies under specific provisions**

***Deductibility to life assurance company under subsection 51(1): former sections 111A and 111AA of the 1936 Act (see paragraphs 18 – 21)***

98. The forgiven amount of a performance based ADL will only be deductible to the extent that it is incurred in the gaining or producing of assessable income. In particular, in the absence of specific provisions allowing deductibility, the forgiven amount of an ADL is not deductible to the extent that it relates to the gaining or producing of non-assessable premiums.

99. Prior to 31 December 1993, sections 111A and 111AA respectively deemed superannuation premiums and the investment component of relevant life assurance policies to be assessable income for the purpose of determining the deductions allowable to a life assurance company. The effect of these provisions was to generate allowable deductions against otherwise non-assessable premiums. That is, former sections 111A and 111AA enabled certain deductions to be claimed under subsection 51(1) against superannuation premiums and the investment component of life assurance policies respectively.

100. Former section 111A operated from 1 July 1988 to 31 December 1993 and former section 111AA operated from 1 January 1990 to 31 December 1993.

101. Certain deductions may be allowable to a life assurance company in relation to a forgiven amount by virtue of the operation of

sections 111A and 111AA, e.g., for direct costs of obtaining exempt Australian life assurance premiums (see paragraph 27 of Taxation Ruling TR 95/28). However, we do not consider that these provisions operate to enable a deduction under subsection 51(1) for amounts of conventional ADLs forgiven or written off. As discussed at paragraph 16, conventional ADLs relate to the preservation of a life assurance company's agency network and are thus of a capital nature. Accordingly, they will be specifically excluded from deduction under subsection 51(1).

***Deductibility to life assurance companies under specific provisions: sections 111AC and 111AD of the 1936 Act (see paragraphs 22 – 25)***

102. Sections 111AC and 111AD, which replaced former sections 111A and 111AA, had effect from 1 January 1994 to 30 June 2000, when Division 320 of the 1997 Act commenced operation. Sections 111AC and 111AD were enacted to resolve uncertainty concerning the extent of the application of sections 111A and 111AA and confirm the original policy intention of those provisions, i.e., to allow life assurance companies deductions which are consistent with the deductions allowable on general principles to deposit takers for the costs of getting in their investments.[2] Sections 111AC and 111AD work by listing specific expenses allowable in obtaining superannuation premiums or RSA contributions (subsection 111AC(2)) and the investment component of certain life assurance premiums (subsection 111AD(3)). These provisions are known as the "positive tests".

103. In determining whether and to what extent the forgiven amount of an ADL is deductible under either section 111AC or 111AD during the relevant periods, it will be essential to identify the nature of business generated by the agent. The forgiven amount will only be deductible under these provisions to the extent that it is incurred in obtaining either superannuation premiums or RSA contributions (section 111AC) and/or the investment component of relevant life assurance premiums (as defined in subsection 111AD(1)).

104. Further, it must be possible to characterise the amount as falling within one of the positive categories listed under each section. Only under paragraphs 111AC(2)(c) and (e) and 111AD(3)(c) and (e) can amounts be apportioned (see paragraph 45 of Taxation Ruling TR 95/28). The amounts will then be deducted to the extent that they are incurred for the purposes stated in those paragraphs.

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[2] Paras 6.2-6.4 of the Supplementary Explanatory Memorandum to the Taxation Laws Amendment Bill (No. 4) 1993.

105. We consider that the forgiven amount of a performance based ADL will be deductible during the relevant periods pursuant to paragraphs 111AC(2)(e) or 111AD(3)(e) to the extent that it is incurred in selling superannuation policies and/or the investment component of relevant life assurance policies respectively.

106. Where the forgiven amount of a performance based ADL represents mixed purpose expenditure, it can be pro-rated between paragraphs 111AC(2)(e), 111AD(3)(e), and subsection 51(1) of the 1936 Act, and section 8-1 of the 1997 Act, depending upon the composition of business written by the agent.

107. Thus, sections 111AC and 111AD will allow deductions during the relevant periods to the extent that the forgiven amount is referable to expenditure for the purposes listed in those provisions. Section 8-1 of the 1997 Act (subsection 51(1) of the 1936 Act) will allow deductions to the extent that the forgiven amount is attributable to the gaining of ordinary assessable income (e.g., accident and disability income). To the extent that the forgiven amount is referable to the gaining or producing of exempt income (e.g., immediate annuity income), it will be non-deductible. In pro-rating deductions for the forgiven amount of a mixed purpose ADL between multiple provisions, the life assurance company should apply the principles stated in Taxation Ruling TR 95/28 at paragraph 45.

108. Sections 111AC and 111AD do not operate to enable a deduction for amounts of conventional ADLs forgiven or written off. Such amounts are of a capital nature (refer subsections 111AC(4) and 111AD(5)).

***Deductibility to life assurance companies under specific provisions: sections 113 and 113A of the 1936 Act - general management expenses (see paragraphs 26 – 27)***

109. Section 113 provides that expenses incurred by a life assurance company in the general management of its business are deductible to the extent that the expenses relate to the gaining or producing of assessable income but are not capital or of a capital nature. Section 113A extends the operation of section 113 to cover general management expenses which are not capital in nature incurred in producing certain specified premiums. These sections operated until 30 June 2000.

110. Expenditure is only deductible under sections 113 or 113A if it is incurred in the managing, as distinct from the carrying on, of the business: *Producers & Citizens' Cooperative Assurance Co. Ltd v. FC of T* (1972) 3 ATR 298; 72 ATC 4196 per Walsh J at ATR 300; ATC 4200-4201 and Stephen J at ATR 302; ATC 4202; see also Taxation Ruling IT 90. The agents to whom ADLs are advanced have no input

into the management of the life assurance company. Accordingly, the forgiven or written off amount of both conventional and performance based ADLs does not constitute a general management expense for the purposes of sections 113 and 113A and will therefore not be deductible under these sections.

***Deductibility to life assurance companies under specific provisions: subsection 25-35(1) of the 1997 Act (subsection 63(1) of the 1936 Act) – the bad debts provisions (see paragraph 29)***

111. We consider that life assurance companies do not carry on a business of lending money to agents. Consequently, we believe that subsection 25-35(1) of the 1997 Act (subsection 63(1) of the 1936 Act) has no application to ADLs.

112. Section 25-35 enables a taxpayer, in certain circumstances, to claim a "bad debt" as an allowable deduction. Under subsection 25-35(1), the debt must have been included in the assessable income of the taxpayer claiming the bad debt (paragraph 25-35(1)(a)) unless it is in respect of money lent in the ordinary course of a "business of lending money" (paragraph 25-35(1)(b)). As the amount of a written off ADL is unlikely to be included in the assessable income of the life assurance company, only the second limb of subsection 25-35(1) ( i.e., paragraph 25-35(1)(b)) will be of relevance for present purposes.

113. It is recognised in Taxation Ruling TR 92/18 that a money lender need not necessarily be willing to lend moneys to the public at large or to a wide class of borrowers. However, the fact that ADL advances are made, not to "all and sundry", but only to high-performing agents, with a view to securing and retaining their services, is one indication pointing against the existence of a money lending business: see *Litchfield v. Dreyfus* [1906] 1 KB 584.

114. In *FC of T v. Australian Mutual Provident Society* ("the *AMP case*") (1953) 88 CLR 450 at 463-64 the High Court said in deciding that the taxpayer's principal business was not the lending of money:

> The Society maintains that its principal business also is the lending of money. That argument was, in our opinion, rightly rejected by the board. The Society's principal business is the business of life assurance, that is to say, the making and performance of contracts to pay, in consideration for premiums paid to it, sums of money on death or on the expiration of a period. Its business differs radically from that of a banker. The lending of money is of the essence of the business of a banker. He provides many other facilities for his customers, but it may be said to be the characteristic of his business that he borrows money in order to lend it. If he ceased to lend money, the nature of his business (assuming it to survive)

> would radically change. A life assurance company lends money, and its lendings are very important, but they are not the essence of its business. They are operations ancillary to the main business, made primarily because the holding of large funds to cover contingent liabilities is a necessity of that business. If a life assurance company ceased to lend money, the nature of its business would not change. The position would simply be that it would have to charge higher premiums in order to maintain itself in a sound position.

115. We accept that the nature of a life assurance company's business has changed considerably since 1953. However, the distinction made between the main life insurance operations of a business and those operations which are ancillary thereto, for example, the making of loans to agents, still has force.

116. It is further accepted that a business of money lending may exist despite the fact that money lending is not the sole, principal or main business of the taxpayer. However, for a money lending business to exist, it is insufficient that the money lending is "merely ancillary or incidental to the primary business": *FC of T v. Marshall & Brougham Pty Ltd* (1987) 18 ATR 859 at 866; 87 ATC 4522 at 4528. In *Marshall & Brougham*, the Full Federal Court held that the taxpayer, a management company for a group of construction companies, was not carrying on a business of money lending because its lending activities were merely ancillary or incidental to its primary business of construction management.

117. A life assurance company will make loans as part of its investment activities. This may be done on a large scale and may be of a commercial nature. However we consider that such loans are made as part of the investment activities of the life assurance company, rather than as part of a separate money lending business. Investment is a necessary part of a life assurance business but this does not mean that life assurance companies can be considered money lenders for the purposes of section 25-35.

118. Even if a life assurance company were considered to be a money lender, a loan must have been made in the ordinary course of the business of money lending to be deductible under section 25-35. In *Franklin's Selfserve Pty Ltd v. FC of T* (1970) 125 CLR 52; (1970) 1 ATR 673; 70 ATC 4079 Menzies J made it clear that losses from lending transactions outside a taxpayer's money lending business were not deductible under section 63.

119. In the case of a life assurance company, loans made in the ordinary course of a money lending business would be considered to be investment loans. We do not consider the making of loans to agents to be part of the ordinary course of that business. Even where such loans are fully repayable and at interest, they are made with the

intention of recruiting and remunerating agents, rather than the making of profits from the lending of money.

*Alternative view*

120. The alternative view is that a life assurance company carries on a business of money lending and should therefore be entitled to a deduction for the written off amount of an ADL under paragraph 25-35(1)(b).

121. It is arguable that life assurance companies, among other things, do carry on a separate business of money lending and that any loans made in the ordinary course of that business which are written off as bad are consequently deductible under section 25-35. In this respect, it is recognised that the lending of money by a modern life assurance company is generally done on a much larger scale than the activities of the taxpayer in *Marshall's case*. As life assurance companies make advances to agents under ADLs as a regular incident of their activities, it is arguable that such loans fall within the ordinary course of the company's wider money lending business.

122. We do not accept this alternative view. We consider that, despite the changes that have occurred in the industry, the decision in the *AMP case* (see paragraph 114) remains as authority for the proposition that the money lending activities of life assurance companies do not constitute the essence of their business.

**In which year can a deduction be claimed? *(see paragraph 32)***

123. For the purposes of section 8-1, losses are only deductible to the extent they are incurred in the year of income. The principles governing the timing of deductibility under section 8-1 are considered to apply equally to the repealed sections 111AC and 111AD of the 1936 Act which also employed the term "incurred".

124. Taxation Rulings TR 94/26 and TR 97/7 set out our views on the interpretation of subsection 51(1) of the 1936 Act (now section 8-1 of the 1997 Act) after the High Court decision in *Coles Myer Finance Ltd v. FC of T* (1993) 176 CLR 640; (1993) 25 ATR 95; 93 ATC 4214 and, in particular, the interpretation of the word "incurred".

125. In the case of performance based ADLs, advanced monies will not be deductible until the performance standards which give rise to the entitlement to forgiveness of the debt are actually met. Until this time, the life assurance company has no presently existing liability to forgive the debt and incurrence of a forgiven amount is, at most, merely pending, threatened or expected. This is not sufficient for a loss or outgoing to be incurred for the purposes section 8-1, no matter how certain it is that the amounts will be forgiven in a future year of

income: see *Nilsen Development Laboratories Pty Ltd v. FC of T* (1981) 144 CLR 616; 81 ATC 4031; (1981) 11 ATR 505. Where a loss has not been realised or an outgoing has not been made, a presently existing pecuniary liability, at the end of the relevant income year, will be a necessary prerequisite to an expense being 'incurred' for the purposes of section 8-1: *Coles Myer Finance* at ATC 4220; ATR 102; *Nilsen Development Laboratories* at ATC 4035; ATR 509.

## Capital losses arising from ADLs

*Capital losses arising from performance based and conventional ADLs which are forgiven (see paragraphs 33 - 42)*

126. Whether a capital gain or loss occurs on the extinguishment of the life assurance company's debt will depend upon (a) the capital proceeds (consideration) received; and (b) the cost base and / or reduced cost base of the debt.

127. Under subsection 110-55(4), the reduced cost base of an asset does not include an amount to the extent that it has already been deducted or is deductible. Consequently, any capital loss upon disposal of an ADL must be adjusted to reflect the extent to which, if any, the forgiven amount has already been claimed as a deduction under section 8-1 of the 1997 Act, subsection 51(1), sections 111AC and/or 111AD of the 1936 Act, or any other relevant provisions.

128. As forgiveness of a traditional security will not constitute a disposal within the meaning of section 26BB (refer Taxation Ruling TR 96/14), the traditional security exemption in subsection 160ZB(6) will have no application to the forgiveness of an ADL.

129. An asset which was owned by a complying fund at 30 June 1988 is deemed, under subsection 306(1) of the 1936 Act, to have been acquired on 30 June 1988 for the purposes of Parts 3-1 and 3-3 of the 1997 Act (Part IIIA of the 1936 Act). This means that there may be capital gains or losses under Part 3-1 or Part IIIA in respect of the disposal of such assets, even though they were acquired before 20 September 1985 and would not otherwise be subject to the CGT provisions.

130. The amount of the debt referable to an ADL will be an asset of the life assurance company as a creditor under section 108-5 of the 1997 Act (subparagraph 160A(a)(ii) of the 1936 Act).

131. Any legally enforceable forgiveness of a debt will be sufficient to constitute CGT event C2 under subsection 104-25(1) of the 1997 Act (paragraph 160M(3)(b) of the 1936 Act); refer CGT Determination Number 2, paragraph 1. This is the case regardless of whether some or all of the debt has previously been written off.

132. If the life assurance company receives no consideration for the extinguishment of an ADL after 15 August 1989 (the date of commencement of the amendments contained in the *Taxation Laws Amendment Act 1990* (No. 35 of 1990)), it will be taken to have received an amount equal to the market value of the debt at the time of disposal: subsection 116-30(1) (Modification 1) of the 1997 Act (paragraph 160ZD(2)(a) and subsection 160ZD(2A) of the 1936 Act).

133. If the extinguishment occurred before 16 August 1989, there will be no deemed disposal at market value, as former subsection 160ZD(2) required disposal to be "to another person" prior to the 1990 amendments. Clearly, no person acquires the debt upon its extinguishment.

134. The life assurance company would also be taken to have received market value on the extinguishment, after 15 August 1989, of the debt when the consideration is less than the market value of the debt: paragraph 116-30(2)(b) of the 1997 Act (paragraph 160ZD(2)(c) of the 1936 Act).

135. The market value of the debt at the time of its disposal must be calculated as though the debt was not extinguished and was never intended to be: subsection 116-30(3A) of the 1997 Act (subsection 160ZD(2A) of the 1936 Act). If the debt is released or cancelled because it is worthless, then the market value will ordinarily be nil, despite subsection 116-30(3A), as the disposal itself does not affect the market value of the debt.

136. Generally, the cost base of the debt will be the face value of the amount of the ADL forgiven: refer CGT Determination Number 2, paragraph 3. The capital loss incurred by the life assurance company will be equal to the reduced cost base of the debt, less any consideration received or taken to be received: subsection 104-25(3) of the 1997 Act (paragraph 160Z(1)(b) of the 1936 Act).

### *Capital losses arising from performance based and conventional ADLs which are written off (see paragraphs 43 – 45)*

137. The above analysis regarding forgiveness of ADLs is equally applicable to the issue of write off with the proviso that the mere action of write off will not, per se, be sufficient to constitute a disposal under the 1936 Act, nor will it constitute a CGT Event under the 1997 Act. As Taxation Ruling TR 92/18 recognises, the mere writing off of a debt does not necessarily relieve the debtor from ever having to pay the liability. It will therefore be necessary for the life assurance company to ensure that the ADL debt has been extinguished before a capital loss will be available. Such an extinguishment might constitute a CGT event C2: see paragraphs 37 and 131.

138. The traditional security exemption in subsection 160ZB(6) will have no application to the write off of an ADL. This is consistent with the conclusions reached in paragraphs 49-58 of Taxation Ruling TR 96/14. If release, forgiveness or waiver do not constitute a disposal for the purposes of section 70B relating to traditional securities, then a mere write off, which does not extinguish the debt, clearly will not.

139. The market value of the debt will be the greater of the excess of expected recoverable funds over expected recovery expenses, or nil. This will depend upon the facts of each individual case. Where the debt is written off by reason of the suspected insolvency of the debtor, the market value of the debt is expected to be less than its full face value. If the debt is released or cancelled because it is worthless, then the market value will be nil, despite subsection 116-30(3A) of the 1997 Act (subsection 160ZD(2A) of the 1936 Act), as the disposal itself is not considered to affect the market value.

## Assessment of agents

### *Assessment of agents: performance based ADLs which are forgiven (see paragraphs 46 – 52)*

140. We consider that forgiveness of a performance based ADL will give rise to the derivation by the agent of the forgiven amount as assessable income. The forgiven amount will be assessable as income according to ordinary concepts pursuant to subsection 6-5(1), or as a benefit or bonus allowed, granted or given directly in consideration for the rendering of services by the agent under paragraph 26(e) of the 1936 Act.

141. The service rendered by the agent consists of the marketing activities undertaken by the agent in relation to the life assurance company's products. The relationship between the agent and the life assurance company thus extends beyond a mere contractual relationship of buyer and seller. In *FC of T v. Cooke & Sherden* (1980) 10 ATR 696; 80 ATC 4140, the Court rejected the contention that the soft-drink retailers were rendering services to the manufacturers, instead holding that their relationship was "essentially one of seller and buyer". Advantages accrued to the manufacturer as a result of the activities of the retailers, but this was independent of any obligation owed to the manufacturer. In the case of ADLs, agents act on behalf of the life assurance company as principals, marketing insurance products on the life assurance company's behalf. The agents are not mere independent purchasers of the life assurance company's products and are doing "more than the mere entering of a contract": cf *Revesby Credit Union Co-operative Ltd v. FC of T* (1965) 112 CLR 564 per McTiernan J at 578.

142. It is only upon forgiveness that a performance based ADL can be characterised as income in the hands of the agent. In the assessment of income, the object is to discover what gains have, during the year of income, "come home" to the taxpayer: *C of T (SA) v. Executor Trustee & Agency Co. of South Australia Ltd* (*Carden's Case*) (1938) 63 CLR 108, per Dixon J at 155. It is clear that, prior to forgiveness, ADL moneys will not have "come home" to the agent in any relevant sense as they remain repayable to the life assurance company. Such money is not received by the agent in a form unaffected by legal restriction or commercial unsoundness: see *Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314 at 318; (1965) 14 ATD 98 at 99. ADL moneys will only come home to the agent in such an unrestricted form upon forgiveness by the life assurance company.

143. We consider that *Case 22/94* (1994) 28 ATR 1155; 94 ATC 225 provides a useful analysis of the treatment of forgiven loan moneys for income tax purposes. There, the taxpayer received an advance from an assistance scheme established for the benefit of the sugar industry. The assistance was, subject to the happening of certain events, automatically forgiven by one-seventh of the assistance sum each year over the period of seven years. The Administrative Appeals Tribunal accepted that the receipts were in substance in the nature of a loan. The Tribunal held, however, to the extent that the assistance ceased to be repayable each year, it changed in character from a loan, to an assessable grant or subsidy.

144. Applying the decision in *Case 22/94*, we consider that upon each forgiveness, the forgiven amount of an ADL assumes the mantle of income by way of payment for past services, and is derived at that point in time, becoming assessable income: refer *Case 22/94* at ATC 231; ATR 1162. It will then be assessable under section 6-5 as income according to ordinary concepts.

145. The case for assessability of forgiven amounts under a performance based ADL is even more compelling than in *Case 22/94* as the agent does not receive the payment automatically, but must "earn" it by providing a sufficient level of service to the lender by way of meeting specified performance standards.

*Reduction in liability as assessable income*

146. In bringing the forgiven amount of an ADL to account as assessable income, effect is given to the principle, established by the High Court in *International Nickel Australia Ltd v. FC of T* (1977) 137 CLR 347, and applied in *Warner Music Australia Pty Ltd v. FC of T* (1996) 34 ATR 171; 96 ATC 5046 ("the *Warner Music case*"), that the release from a debt or reduction in a liability incurred in the ordinary course of business or as an ordinary incident of business will

give rise to the derivation of income by the debtor. In the case of ADLs, we consider that forgiveness of a performance based ADL will constitute a reduction in the agent's liabilities that will lead to the derivation of an assessable gain to the agent.

147. This will be the case even though the reduction of an agent's liability through forgiveness may be "infrequent" or "abnormal". We consider that the derivation of gains by the agent in this manner is so closely connected with the business of the agent that it must be treated as being an incident of that business: see *Warner Music* at ATR 182; ATC 5056.

*Normal operation in ordinary course of business*

148. We also consider that the forgiven amount of a performance based ADL will generally constitute gross earnings or proceeds received from a transaction entered into in the ordinary course of the agent's business.

149. The forgiven amount is in the nature of a bonus for high performance and is therefore considered to have the same character as commission income derived by the agent through the sale of life assurance policies. Receipt of forgiven amounts is part of the agent's overall remuneration package derived by the rendering of services to the life assurance company in the ordinary course of business.

*Business operation or commercial transaction with profit-making purpose or intention*

150. The receipt of money through forgiveness of an ADL may instead be characterised as the derivation of assessable income by the agent from a business operation or commercial transaction entered with the intention or purpose of making a relevant profit or gain: *FC of T v. Myer Emporium* (1987) 163 CLR 199; (1987) 18 ATR 693; 87 ATC 4363. Our views on the operation of these principles are set out in Taxation Ruling TR 92/3.

151. Whether or not such a characterisation is correct will depend upon whether, in the facts of the individual case, the agent has made a profit or gain from the ADL transaction and whether the agent entered into the transaction with the intention of making the gain.

*Forgiveness for reasons extraneous to rendering of service (see paragraphs 53 – 54)*

152. It is conceivable that a performance based ADL may be forgiven for reasons extraneous to the rendering of service by the agent to the life assurance company. In such a case, the forgiven

amount will not be assessable pursuant to paragraph 26(e): see *Smith v. FC of T* (1987) 19 ATR 274 per Brennan J at 280; 87 ATC 4883 at 4889 and 4890. Equally, if the forgiven amount can be characterised as a mere gift, it would not be assessable pursuant to subsection 6-5(1), as there would be an insufficient nexus between the payment and the agent's income-earning activities.

153. However, we consider it unlikely that an agent would be able to show that a forgiven amount had come home to them for reasons bona fide and genuinely extraneous to their business relationship with the life assurance company. In considering the character of a receipt in the hands of the recipient, it is necessary to have regard to all the circumstances which give rise to the receipt without a disproportionate emphasis being given to the form in which the transaction is structured: *FC of T v. Co-operative Motors Pty Ltd* (1996) 31 ATR 88; 95 ATC 4411. We consider that forgiveness of an ADL, even if voluntary, will in most cases occur in the context of a business relationship between the agent and the life assurance company related in some manner to services rendered, and will therefore not constitute a mere gift.

154. Nonetheless, if it can be shown in the circumstances that the forgiveness of an ADL represents, in substance, a mere gift, the forgiven amount may be subject to the commercial debt forgiveness provisions in Schedule 2C (see Example at para 189 below). It would be necessary to have available evidence to satisfy the Commissioner that the reasons for forgiveness were unrelated to the rendering of services.

*The "restrictive covenant" cases*

155. In some cases, an ADL agreement may include terms which restrict the agent's freedom to act for other life assurance companies. It is a question of fact whether or not the forgiven amount of an ADL represents consideration for the grant of a restrictive covenant. Accordingly, this can only be determined on the facts of the individual case. However, we consider that in almost every case that can be envisaged, the forgiven amount will be received in consideration for the achievement of performance targets and will have no relevant connection with any restrictive covenant provided by the agent.

***Assessment of agents: performance based ADLs which are written off (see paragraphs 55 – 56)***

156. If a performance based ADL is written off in recognition of the fact that the loan is presently bad, the written off amount will retain the character of a loan amount in the hands of the agent. As at the

date of write off, there will have been no event which has occurred so as to change the character of the moneys from a loan into income.

157. The mere writing off of a debt does not necessarily relieve the debtor from ever having to pay the liability: see Taxation Ruling TR 92/18 at paragraph 39. If the financial position of the debtor subsequently improves or the circumstances which led to the write off change, action may be taken to pursue the debt. Upon this basis, it is difficult to envisage how the written off amount could be regarded as having come home to the agent.

*Assessability of written off amounts under paragraph 26(e) of the 1936 Act*

158. Paragraph 26(e) will generally not apply to the written off amount of the ADL, as mere writing off of the loan does not change the character of the advance as a loan.

***Assessment of agents: conventional ADLs which are forgiven (see paragraphs 57 – 59)***

159. A life assurance company may vary a conventional ADL agreement by entering a new agreement with an agent which provides for future forgiveness of amounts of the original loan and/or further amounts on the meeting of specified performance standards by the agent. If this occurs, we consider that the conventional ADL will become a performance based ADL from the date of entering into the new agreement. The analysis given above at paragraphs 140-155 is then applicable.

160. It is possible that a conventional ADL may be forgiven by the life assurance company in recognition of the agent meeting a high level of sales, but not pursuant to any pre-existing agreement or understanding to do so. This may occur where, for example, an agent is in financial difficulty, but is still producing substantial business for the life assurance company. Where the forgiveness of the loan is properly regarded as being in recognition of outstanding sales, the forgiven amount will be characterised as a bonus or reward in relation to the services rendered by the agent to the life assurance company. The amount will therefore be assessable under section 6-5 of the 1997 Act or paragraph 26(e) of the 1936 Act. The fact that forgiveness of the loan is on capital account in the books of the lending life assurance company does not prevent the amount being income in the hands of the agent. Likewise, the fact that the payment is in recognition of past service does not prevent it from being income in the hands of the agent. A receipt characterised as additional remuneration for past services rendered may be income according to ordinary concepts: see *Carter v. Wadman* (1946) 28 TC 41; *FC of T v. Co-operative Motors*

(above) and *AAT Case 4338*; *Case V76* (1988) 19 ATR 3496; 88 ATC 538.

161. The fact that forgiveness of a conventional ADL will arise from an act of the life assurance company which is voluntary in nature does not deter the conclusion that forgiveness renders the forgiven amount assessable to the agent: *Co-operative Motors* and *Case V76*.

*Forgiveness for reasons extraneous to rendering of service*

162. It is only in the highly unlikely event of a life assurance company forgiving a conventional ADL for reasons bona fide and genuinely extraneous to the rendering of services by an agent that the forgiven amount of the ADL will be non-assessable. This may occur where, for example, an ADL is forgiven by the life assurance company by way of a gift to the agent. It would be necessary to have available evidence to satisfy the Commissioner that the reasons for the forgiveness were unrelated to the rendering of services. In such a case, the forgiven amount will constitute a non-assessable receipt: *Scott v. FC of T* (1966) 117 CLR 514; 14 ATD 286.

*Assessability of forgiven amounts under paragraph 26(e) of the 1936 Act*

163. The forgiven amount of a conventional ADL may instead be assessable pursuant to paragraph 26(e) as a reward for services rendered. There is no doubt that voluntary payments may fall within paragraph 26(e): *FC of T v. Dixon* (1952) 86 CLR 540 at 558; *Smith v. FC of T* (1987) 19 ATR 274 at 280; 87 ATC 4883 at 4888.

***Assessment of agents: conventional ADLs which are written off (see paragraphs 60 – 61)***

164. Where a life assurance company writes off a conventional ADL as irrecoverable, the written off amount of the ADL will not constitute income derived by the agent. In this context, it is irrelevant whether or not the amount is written off as a commercially irrecoverable debt.

***Application of the capital gains tax provisions (see paragraphs 62 - 63)***

165. For CGT purposes, a borrower is not considered to own an asset: refer CGT Determination Number 3, at paragraph 1. Accordingly, when the life assurance company forgives or writes off an amount of an ADL, the agent will not be taken to have made a capital gain or loss.

166. As we consider the forgiven amount of a performance based ADL to be assessable on revenue account, the amount of the capital gain will be reduced pursuant to paragraph 118-20(1)(a) (subsection 160ZA(4) of the 1936 Act). Where the amount of capital gain does not ordinarily exceed the amount which would be assessable as ordinary income, the amount of capital gain will be reduced to nil: paragraph 118-20(2)(a) (paragraph 160ZA(4)(d) of the 1936 Act). The impact of Part 3-1 (Part IIIA of the 1936 Act) in such a case will therefore be inconsequential.

**Division 245: forgiveness of commercial debts (Schedule 2C)** ***(see paragraphs 64 – 74)***

167. Subsection 245-15(3) of the 1936 Act provides that an amount is not regarded as a debt if the amount would have been or will be included in the assessable income of the debtor. In the case of debts arising under ADLs which are forgiven in recognition of services rendered by the agent, Schedule 2C will not apply, as these amounts will be included in the assessable income of the agent either under section 6-5 or paragraph 26(e). Further, as "forgiveness" is a threshold requirement of Schedule 2C, only debts arising under ADLs which are forgiven will attract the operation of the Schedule: subsection 245-10(1). This may occur where the debt is extinguished after having been written off as bad, or where the debt is forgiven for reasons extraneous to the rendering of service by the agent to the life assurance company.

168. Although a liability arising under an ADL will fall within the definition of a debt in subsection 245-15(1), the debt must also be "commercial" for Schedule 2C to apply: subsection 245-10(1). A debt is only commercial if interest paid on it by the debtor is, ignoring exemption provisions, deductible to the debtor, or would be if interest were payable: section 245-25. Thus, Schedule 2C will not apply unless the agent is using the advanced ADL monies for a purpose which would give rise to a deduction for any interest that is or would be payable.

***What constitutes forgiveness of a debt***

169. A commercial debt is forgiven where the debtor's obligation to pay the debt is released or waived or otherwise extinguished: subsection 245-35(1). We consider that the act of the life assurance company of releasing the agent from the liability to pay the debt will constitute a forgiveness of the debt for the purposes of Schedule 2C: subsection 245-35(1).

170. In the case of write off, it will depend upon the facts of the individual case whether a forgiveness has occurred within the

meaning of subsection 245-35(1). A mere write off will not extinguish the debt and does not therefore constitute forgiveness. However, if the debt is written off and subsequently extinguished, a forgiveness will arise within the meaning of Schedule 2C. However, if the debt is subsumed into bankruptcy proceedings, the operation of Schedule 2C will be precluded by paragraph 245-40(a) of the Schedule.

171. We consider that the forgiveness would occur at the time at which the life assurance company waives the agent's liability to repay or otherwise extinguishes the debt.

172. Where the debts arising under an ADL are gratuitously forgiven, there is unlikely to be an agreement or arrangement under which the debtor's obligation is to cease at a particular future time: see paragraphs 245-35(3)(a) and (b). Consequently, we do not believe that subsection 245-35(3) will operate to deem the time of forgiveness to be when the agreement or arrangement is entered into. The existence of such an agreement would render the ADL performance based, thereby placing it outside the operation of Schedule 2C.

### *Valuing the debt: calculating net forgiven amount*

173. Valuation requires the calculation of the gross forgiven amount of the debt in accordance with Subdivision 245-C, and the net forgiven amount of the debt in accordance with Subdivision 245-D. This involves a four-step process.

### *Notional value*

174. Firstly, the "notional value" of the debt is determined. Generally, the notional value of a debt is the lesser of the "first applicable amount" and the "second applicable amount" of a debt: subsection 245-55(1).

175. The "first applicable amount" is the amount which would have been the value of the debt at the time of forgiveness if, at the time when the debt was incurred, the debtor was able to pay all debts as and when due and that capacity had not changed: subsection 245-55(2).

176. The "second applicable amount" in subsection 245-55(3) is the sum of two separate amounts, identified in paragraphs (a) and (b). The paragraph 245-55(3)(a) amount consists of the amount which would have been the value of the debt at the time of forgiveness if at the time when the debt was incurred, the debtor was able to pay all debts as and when due, that capacity did not change, and there were no changes in any market variables. The paragraph 245-55(3)(b) amount consists of all deductions that are allowed or allowable to the

debtor as a result of the forgiveness of the debt and are attributable to changes in market variables that have occurred between the time that the debt was incurred and forgiveness of that debt.

177. In the case of ADLs, we consider that the notional value of the debt will generally be equal to the amount of the ADL forgiven.

### *Consideration*

178. Secondly, the consideration in respect of the forgiveness of a debt is characterised under section 245-65.

179. A "moneylending debt" is a debt resulting from a loan of money to the debtor made by the creditor in the ordinary course of a business of lending money carried on by the creditor: subsection 245-245(1). As previously noted, we do not consider that life assurance companies are in the business of lending money to agents. As a debt arising under an ADL is not a moneylending debt, the "consideration" will be the amounts which the agent has paid or is required to pay as a result of the forgiveness of the debt: subparagraph 245-65(1)(a)(i).

180. Where a performance based ADL is forgiven and the arrangement for the forgiveness of the debt requires payment to be made, but there is no consideration given by the agent to the life assurance company, paragraph 245-65(2)(a) will operate to deem the agent to have paid an amount in respect of the forgiveness equal to the market value of the debt at the time of forgiveness. This provision does not apply unless the arrangement requires payment to be made as consideration for the forgiveness.

### *Gross forgiven amount and net forgiven amount*

181. Thirdly, the gross forgiven amount is determined. Where no consideration is paid or deemed to be paid by the agent to the life assurance company upon forgiveness of the debt arising under the ADL, the gross forgiven amount of the debt will be equal to the notional value of the debt at the time of forgiveness (subsection 245-75(1)) and the gross forgiven amount will equal either the first applicable amount or the second applicable amount (see paragraphs 174-176).

### *Application of net forgiven amount to other amounts*

182. Finally, under subsection 245-85(1), the gross forgiven amount is reduced by three reduction factors, which would otherwise cause a potential increase in the liability of the agent as a result of the forgiveness.

183. Under paragraph 245-85(1)(a), amounts which have been or will be included, under a provision other than Division 245, in the assessable income of the debtor as a result of forgiveness of the debt arising under the ADL, are offset against the gross forgiven amount. It is difficult to envisage a situation in which an agent would receive an assessable amount which is not referable to the enforceable obligations created by the ADL, and therefore outside the operation of subsection 245-15(3). However, if the agent were to receive such an amount, this amount must be applied in reduction of the gross forgiven amount.

184. Under paragraph 245-85(1)(b), the amount by which a deduction that would have been allowable to the debtor under a provision other than Division 245 is reduced as a result of the forgiveness of the debt must be offset against the gross forgiven amount. This will be of relevance, for example, to an ADL which carries interest and is being used by the agent for a purpose which renders the interest deductible. In this case, the amount, if any, by which the agent's interest obligations are or will be reduced as a result of forgiveness will need to be applied in reduction of the gross forgiven amount.

185. Providing there are no agreements between companies under common ownership to forgo a capital loss or revenue deduction, the amount remaining after deduction of the above reduction factors will constitute the net forgiven amount: paragraph 245-85(2)(a).

186. Where the ADL does not carry interest, and forgiveness does not lead to a reduction in the cost base of any of the assets held by the agent, the gross forgiven amount will equal both the net forgiven amount and the amount of the debt forgiven.

187. The net forgiven amounts of the debts forgiven for the year of income are aggregated pursuant to subsection 245-105(1) to calculate the "total net forgiven amount". If more than one debt is forgiven in a year, the sum of the amounts forgiven will be treated as a single forgiven amount. The total net forgiven amount is applied in the following order (sections 245-96 and 245-105):

- To reduce revenue losses (sections 245-110 to 245-120);
- To reduce net capital losses (sections 245-125 to 245-135);
- To reduce future deductions for particular expenditure (section 245-140 to 245-160); and
- To reduce the cost bases of certain assets (sections 245-165 to 245-190).

188. Where the amount forgiven exceeds the amounts in section 245-105, the excess will not be assessable: section 245-195.

# Example

189. Lonsdale Life Assurance Company entered into an agency agreement with Opportunity Pty Ltd on 1 February 1993. At the same time, Lonsdale loaned Opportunity $250,000 under a conventional ADL agreement. The loan was repayable on 31 January 2007. Opportunity utilised the funds in business-related investments.

190. After reviewing its agency arrangements, Lonsdale discovered that Opportunity was one of its highest performing agents, and decided to reward Opportunity for its outstanding performance. Accordingly, on 1 February 1995, Lonsdale agreed to forgive $60,000 of the loan amount immediately, and to enter into a new agreement, which provided for forgiveness of further amounts conditional upon Opportunity meeting certain specified performance standards, including sales targets. Lonsdale agreed to forgive amounts owed under the ADL as follows:

| **Amount** | **Date of forgiveness** |
|---|---|
| 1. $60,000 | 1 February 1995 |
| 2. $80,000 | 1 February 1999 |
| 3. $60,000 | 1 February 2003 |
| 4. $50,000 | 31 January 2007 |

191. The composition of business written by Opportunity for Lonsdale was represented by the following classes of income in the 1994/95 and 1998/99 years of income[3]:

| **Class of Business** | **Proportion of Total Business** |
|---|---|
| Accident and Disability | 5% |
| Complying Superannuation | 80% |
| Residual Life Assurance (Term Policies) | 5% |
| Immediate Annuity | 10% |

[3] These were the classes of business relevant to Division 8 of the 1936 Act prior to its replacement by Division 320 with effect from 1 July 2000.

| | |
|---|---|
| Total | 100% |

192. Opportunity achieved its sales targets up to 1 February 1999 and Lonsdale therefore forgave an amount of $80,000. In February 2002, Lonsdale reviewed its agency agreements and decided to cancel its agreement with Opportunity. It then called in the outstanding loan, which Opportunity was unable to repay, as it had been lost in failed investments. After discovering that the directors of Opportunity had absconded, Lonsdale determined that the ADL debts were worthless. At that time Lonsdale determined to write off the balance of $110,000. As at 30 June 2002, Opportunity had revenue losses of $60,000 and capital losses of $70,000.

***Deductible amounts: Lonsdale***

193. Lonsdale can claim deductions in the following manner:

| **Class of business** | **ITAA section** | **Year 1994/95 ($)** | **Year 1998/99 ($)** |
|---|---|---|---|
| Accident and Disability | s 8-1 / ss 51(1) | Nil[1] | 4,000.00 |
| Complying Superannuation | para 111AC(2) | Nil[1] | 64,000.00 |
| Residual Life assurance | para 111AD(3) | Nil[1] | 4,000.00 |
| Total | | Nil | 72,000.00 |

[1] The forgiveness of the $60,000 on 1 February 1995 occurred in recognition of past services rather than meeting specified performance targets. As stated at paragraph 92, this amount is not deductible.

***Non-deductible amounts: Lonsdale***

194. The amounts that Lonsdale is unable to claim deductions for are:

| Class of business | ITAA section | Year 1994/95 ($) | Year 1998/99 ($) |
|---|---|---|---|
| Conventional loan forgiven | | 54,000[1] | |
| Immediate Annuity | | 6,000[1,2] | 8,000[2] |
| Total | | 60,000 | 8,000 |

[1] The forgiveness of the $60,000 on 1 February 1995 occurred in recognition of past services rather than meeting specified performance targets. As stated at paragraph 92, this amount is not deductible.

[2] To the extent that the forgiven amount is referable to the gaining or producing of immediate annuity income (i.e., exempt income), it is non-deductible.

***Losses: capital gains tax consequences for Lonsdale***

195. The deductible amounts totalling $72,000 must be offset against the cost base of the debt under subsection 110-55(4).

196. If Lonsdale merely writes off the remaining $110,000 outstanding, it will not be entitled to claim any capital loss relating to this amount. However, if Lonsdale executes a legally effective extinguishment of the debt, it may include the $110,000 amount in the cost base of its debt under subsection 104-25(3).

197. Lonsdale can also include in the cost base of its debt under subsection 104-25(3):

- the $14,000 forgiven amount ($6,000 of which was forgiven on 1 February 1995 and $8,000 of which was forgiven on 1 February 1999) referable to the generation of exempt income from immediate annuities; and
- the $54,000 amount forgiven on 1 February 1995 referable to the generation of accident and disability, complying superannuation, and residual life assurance income.

198. Lonsdale will be deemed, under subsection 116-30(1), to have received the market value of the $178,000 debt. As the debt is worthless, its market value will be nil. Lonsdale may claim a capital loss upon the following basis:

| | |
|---|---|
| Face Value of Debt | $250,000.00 |
| Less: Deductible Amounts (ss110-55(4)) | $72,000.00 |
| Reduced Cost Base of Debt (s110-55) | $178,000.00 |
| Capital Proceeds Received (ss116-30(1)) | Nil |
| Capital Loss (CGT event C2) | $178,000.00 |

***Income: assessability of Opportunity***

199. The $140,000 that is forgiven by Lonsdale to Opportunity will be assessable income of Opportunity. $60,000 is derived in 1994/1995 and $80,000 is derived in 1998/1999. The $110,000 written off by Lonsdale will not be assessable income of Opportunity. Nor will the $110,000 'come home' to Opportunity as assessable income if Lonsdale subsequently legally extinguishes the debt in the circumstances described at paragraph 196. In this situation, the legal extinguishment is not related to services rendered by Opportunity to Lonsdale in the context of a business relationship but is rather in recognition of the fact that the loan is irrecoverable (refer paras 152-154 above).

200. Although the write off by Lonsdale will not constitute a 'forgiveness' as determined by subsection 245-35(1) of Schedule 2C, a subsequent legally effective extinguishment of the debt will constitute a 'forgiveness'. If the debt is extinguished, Schedule 2C will apply in the following manner:

| | |
|---|---|
| Notional Value (ss245-55(1)) | $110,000 (First Applicable Amount) |
| Consideration | nil |
| Gross Forgiven Amount (ss245-75(2)) | $110,000 |
| Net Forgiven Amount (ss245-85(2)) | $110,000 |

201. The sum of $110,000 would be used to reduce Opportunity's revenue losses to nil and its capital losses to $20,000.

| | Revenue ($) | Capital ($) |
|---|---|---|
| Losses as at 30 June 2002 | 60,000 | 70,000 |
| Net Forgiven Amount applied to losses | 60,000[1] | 50,000[2] |
| Losses remaining after application of Schedule 2C | nil | 20,000 |

[1] Net forgiven amount is applied firstly to reduce any available revenue losses. In this case the quantum of revenue losses is $60,000, against the net forgiven amount of $110,000. Hence all revenue losses are reduced to nil, and a balance of $50,000 is available to reduce capital losses.

[2] See note 1. Balance of $50,000 of the net forgiven amount is applied to reduce net capital losses of $70,000, thus leaving $20,000 of net capital losses to be applied against any other net capital gains, or to carry forward to a later income year.

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**Commissioner of Taxation**
19 September 2001

*Previous draft:*

Previously released in draft form as TR 2000/D18

*Related Rulings/Determinations:*

IT 90; TR 92/3; TR 92/18; TR 92/20; TR 93/38; TR 94/26; TR 95/3; TR 95/28; TR 96/14; TR 97/7; CGT 2; CGT 3

*Subject references:*

- Agency Development Loans
- Life Assurance Companies
- Life assurance agents
- Debt Forgiveness
- income v capital

*Legislative references:*

- ITAA 1936 21A
- ITAA 1936 25(1)
- ITAA 1936 26(e)
- ITAA 1936 26BB
- ITAA 1936 26BB(1)
- ITAA 1936 51(1)
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ATO references:
NO: 96/2492-9
BO:
FOI: I 1021015
ISSN: 1039-0731