ANOTHER TWIST IN THE TAX MAZE

SPOTLIGHT ON DEFERRED INTEREST

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In attempting to level the tax treatment of interest-bearing securities, the Taxation Office has added to the volume of legislation confronting investors.

The taxation implications of any investment are an important consideration in evaluating the overall return on a particular investment or portfolio. The holders of deferred or discounted securities now have an additional element to consider in analysing the taxation implications of investing in certain securities, following the introduction of further legislation into the already complex Income Tax Assessment Act (ITAA).

The changes in the treatment of certain securities are contained in Taxation Laws Amendment Bill (No. 3) 1989. The legislation will add new sections 26BB, 70B and 160ZB(6) to the ITAA. The legislation is intended to apply to what are called "traditional securities".

The term "traditional security" presumably stems from the Treasurer's Explanatory Memorandum on the introduction of Division 16E into the ITAA. Division 16E applies to discounted and other deferred-interest securities in contrast to what might be termed "traditional interest-bearing securities". Division 16E alters the basis for taxing income accruing on discounted and other deferred interest securities from a strict realisation basis to an accruals basis. Division 16E was introduced in 1986 largely in response to a perceived anomaly in the taxation of deferred-interest securities highlighted in the case of *FCT v. Australian Guarantee Corporation Limited*.[1]

The Australian Guarantee case is an example of the ITAA not incorporating a matching principle. That is, the timing of the derivation of income brought home by one taxpayer generally will not determine when a loss or outgoing is incurred by another taxpayer.[2] The timing advantages that many discounted and deferred-interest securities enjoyed were seen as detrimental to the interests of the revenue. This is because interest is usually derived for taxation purposes only when received and not as it is accrued from day to day.

Deferred-interest securities were a means of deferring receipt of interest and therefore deferring the taxing point on that interest income. On the other hand, interest expense is deductible when it is incurred under Section 51(1)(ITAA). Division 16E seeks to overcome this by providing that an investor bring the yield of certain "qualifying securities" to account as assessable income as the interest accrues.

For the purposes of the traditional securities legislation, the terms "security" and "eligible return" have the same meaning as in Division 16E. The term "traditional security" is defined as a security held by a taxpayer that:

- is or was acquired by the taxpayer after May 10, 1989;
- either:
  - does not have an eligible return; or
  - has an eligible return, where the precise amount of the eligible return is able to be ascertained at the time of the

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issue of the security. In contradistinction to securities which will fall under Division 16E, the amount of the eligible return of a traditional security must be not greater than 1.5 per cent of PAYMENTS x TERM. The payments in the calculation, as above, exclude any periodic interest payments made.

The following example demonstrates the operation of this formula in relation to a hypothetical bond issue:

If a company issues a bond with a three-year term and a face value of $100,000 at a discount price of $95,000, the eligible return in relation to that bond will be $5,000 (that is, the amount by which the payments to be made under the bond, excluding interest payments, exceeds the issue price). To come within the ambit of Division 16E, that eligible return of $5,000 must be greater than 1.5 per cent of the payment ($100,000) multiplied by the number of years in the term; that is, greater than $4,500.

In the alternative, if the same bond was issued at a discount price of $97,000 the amount of the eligible return would be $3,000, which is less than 1.5 per cent of PAYMENTS x TERM and would therefore be brought into assessable income under section 26BB as a traditional security. Section 26BB(2) provides that where a taxpayer disposes of or redeems a traditional security, the amount of any gain on the disposal or redemption shall be included in the assessable income of the taxpayer in the year of income in which the disposal or redemption takes place.

The new section 70B states that expressions used in the section that are also used in section 26BB shall have the same meaning. Section 70B will allow the amount of any loss on the disposal or redemption of a traditional security as an allowable deduction of the taxpayer in the year of income in which the redemption or disposal takes place.

Section 160ZB of the capital gains tax provisions will be amended to include new subsection (6) which states that a capital gain shall not be taken to have accrued to a taxpayer, and a capital loss shall not be taken to have been incurred by a taxpayer, as the result of the disposal of a traditional security, where the security was acquired by the taxpayer after May 10 1989. One significant feature of the new legislation is that securities that would have been brought to assessable income under the capital gains tax, but for the traditional securities legislation, will now be denied the benefit of indexation.

We understand from discussions with the Taxation Office that the rationale behind the new legislation is to bring about consistency in the ITAA in the treatment of what the Taxation Office considers to be "interest". Those securities that fall into the category of traditional securities will be denied the benefit of indexation that formerly would have been obtained under the capital gains tax and the treatment of traditional securities will be brought broadly into line with Division 16E.

The new legislation is not seen by the Taxation Office as a revenue-raising amendment and it has been emphasised that trading stock is specifically exempted from the legislation under section 26BB(1)(d).

Many holders of traditional securities will be larger institutions to whom the securities will be trading stock and therefore will neither be subject to Division 16E nor to the new provisions. However, in the case of banks and life insurance companies the trading stock provisions may not apply. In such cases, Division 16E and the new traditional securities legislation may apply.

Section 26BB also has an anti-avoidance provision contained in subsection (3). This states that where the Commissioner, having regard to any connection between the parties to the transaction by which a taxpayer disposed of, redeemed, or acquired the traditional security, is satisfied that the parties are not dealing at arm's length, he may include an amount in the assessable income of the taxpayer that might reasonably be expected for the transaction if the parties *were* dealing at arm's length. Further, where this is not possible, the Commissioner may impose such amount as he determines.

It is clear from the wording of section 26BB that the section applies to securities acquired on the secondary market at a premium or discount on the face value of the security. Further, the definition of traditional security, unlike a qualifying security in Division 16E, is not limited to securities of a term which, ascertained at the time of issue will, or is reasonably likely to, exceed one year. The requirement that the term of the security exceed one year in Division 16E will by definition exclude most instruments traded on the short-term money market.

Further, the new traditional securities legislation requires that the eligible return on the security be not greater than 1.5 per cent of PAYMENTS x TERM. This requirement would therefore exclude all but the most exceptional security on the short-term money market. By way of example, a bill of exchange of say 90 or 180 days would typically exceed the 1.5 per cent benchmark. Therefore, as with Division 16E, the question of assessability and deductibility of accrued interest will still be relevant for many taxpayers [3].

It should also be noted that the traditional securities legislation includes in the assesssable income of a taxpayer the amount of any "gain" on disposal or redemption of the security. From a drafting point of view, this is an unusual word to use in the context of the taxation of income rather than of capital gains. The use of the word *gain* may lead to disputes as to the amount to be included in the income of the taxpayer. That is, what costs, if any, are to be taken into account in the calculation of the gain? Further, it could be argued that *gain* should include a consideration of indexation (as in the capital gains tax legislation).

The introduction of these new rules will therefore affect the taxation treatment of various securities held by investors. This may result in a shift in the attractiveness of those securities as holders attempt to maximise the after-tax return of their investments. Clearly, and perhaps unfortunately, various securities will need to be considered under different provisions of the Act when preparing tax returns for a particular entity. Specifically, the taxation implications of each security will now need to be considered under:

- Division 16E
- the new traditional securities legislation;
- the capital gains provisions; and
- sections 25(1) and 51(1)

Therefore, while the Treasury is seeking to achieve consistency in the treatment of what the Tax Office consider is interest, it has increased the volume of legislation to be analysed by a security-holder. ☐

NOTES

1. 84 A. T. C. 4642.
2. C. M. Butler, J. M. Hamer, M. G. Crowe, "The Taxation of Discounted Securities and Interest Withholding Tax," *The Taxation Institute of Australia (Victorian Division)*, July 23 1987.
3. J. M. Hamer, "Division 16E," pp 6-7, *The Taxation Treatment of Discounted Securities and Interest Withholding Tax.*