

Taxation treatment of Exchange-traded Australian Government Bonds



27 March 2013

This document is provided as general information only and does not consider anyone's specific objectives, situation or needs. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. None of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© Deloitte Tax Services Pty Ltd, March 2013¹

Contents

1	<i>Exchange-traded Australian Government Bonds – background</i>	3
1.1	Some definitions and explanations	4
1.1.1	What are AGBs?	4
1.1.2	What are Exchange-traded AGBs?	4
1.1.3	Types of Exchange-traded AGBs	4
1.1.4	Parties involved in Exchange-traded AGB transactions	4
1.2	Types of holders	5
1.2.1	Traders	5
1.2.2	Speculators	6
1.2.3	Investors	6
1.2.4	Superannuation funds	6
1.2.5	Managed investment trusts (MITs)	6
1.3	Nature of interest held	6
2	<i>Income tax treatment of Exchange-traded AGBs</i>	8
2.1	Overview of taxation provisions	8
2.1.1	Taxation of Financial Arrangements	8
2.1.2	Trading stock	8
2.1.3	Traditional securities	9
2.1.4	Qualifying securities	9
2.2	Income tax treatment of TBs	10
2.2.1	Taxation where TOFA applies	10
2.2.2	Taxation where TOFA does not apply	11
2.3	Income tax treatment of TIBs	13
2.3.1	Taxation where TOFA applies	13
2.3.2	Taxation where TOFA does not apply	15
3	<i>Summary of realisation of profits or losses</i>	16
3.1	Taxation where TOFA applies	16
3.2	Taxation where TOFA does not apply and holder is not a trader	16
3.3	Taxation where TOFA does not apply and holder is a trader	17
4	<i>Concluding comments</i>	18
4.1	Calculation of accrual amounts	18
4.2	Trading, speculating or investing	18
4.3	Borrowing costs and Exchange-traded AGBs	18
4.4	TOFA	18
4.5	Tax reform	18

1 Exchange-traded Australian Government Bonds – background

Legislation was enacted on 17 November 2012 to enable retail investors to trade Commonwealth Government Securities on an exchange.² As a result of this legislation, the Australian Securities Exchange (ASX) now provides investors with access to interests in Australian Government Bonds (AGBs) that can be traded on the ASX at any point prior to maturity (Exchange-traded AGBs).

This paper examines the income tax consequences of holding Exchange-traded Treasury Bonds (TBs) and Exchange-traded Treasury Indexed Bonds (TIBs), both of which are types of Exchange-traded AGBs. This paper includes comments on the income tax implications of the Taxation of Financial Arrangements (TOFA) provisions, as well as the income tax implications for traders and investors (whether they are individuals, trusts or companies) that fall outside of TOFA. Examples of the taxation consequences are provided throughout the paper. All examples assume the holder has provided their tax file number or Australian business number.

The income tax consequences of dealing in Exchange-traded AGBs will depend upon, amongst other things, the tax residency of the taxpayer. Australian residents are generally assessable on their worldwide income. Taxpayers that are not Australian residents are generally assessable only on Australian-sourced income. For most purposes, source is undefined in the income tax legislation and is a matter of common law. Generally speaking, gains derived from Exchange-traded AGBs are likely to have an Australian source, so any gain that is taxable in the first place would be taxable in Australia.

Australia has double tax agreements (DTAs), however, with a number of countries that exempt the Australian income and capital gains of residents of other countries from tax in Australia. Various exemptions for business profits and capital profits may apply. There are exclusions to the exemptions (for example, if the overseas resident has an office in Australia). As exploring these topics would greatly extend the length of this paper, this paper is confined to a discussion of Exchange-traded AGB transactions entered into by Australian residents.

However, it is anticipated that interest on Exchange-traded AGBs paid to foreign residents will be exempt from interest withholding tax. The Australian Office of Financial Management (AOFM) provides information on Treasury Bonds and Treasury Indexed Bonds, including whether the interest withholding tax exemption applies to a particular issue. Refer to:

- For Treasury Bonds: [click here](#)
- For Treasury Indexed Bonds: [click here](#).

We understand that the Australian Taxation Office has confirmed with the AOFM that the manner in which the Exchange-traded AGBs are issued will not prevent interest paid to foreign residents on Exchange-traded AGBs from being exempt from withholding tax, provided the public offer test and the other conditions in section 128F of the *Income Tax Assessment Act 1936* (the 1936 Act) are satisfied for the underlying Treasury Bonds and Treasury Indexed Bonds.

1.1 Some definitions and explanations

Finance and taxation law use many specialised terms. So that it is clear how these terms are being used, some definitions and explanations are set out below.

1.1.1 What are AGBs?

AGBs are debt securities issued by the Commonwealth of Australia (Australian Government).³

1.1.2 What are Exchange-traded AGBs?

Retail investors who purchase Exchange-traded AGBs on the ASX acquire a beneficial interest in an AGB in the form of a CHESS Depository Interest (CDI). A CDI is a financial product which is a unit of beneficial ownership in an underlying financial product which is quoted on the ASX market.⁴ CDIs are explained in more detail below in the context of the parties involved in Exchange-traded AGB transactions.

1.1.3 Types of Exchange-traded AGBs

There are two types of Exchange-traded AGBs traded on the ASX.

Exchange-traded Treasury Bonds (TBs)

TBs represent beneficial interests in medium- to long-term debt securities issued by the Australian Government that carry an annual rate of interest (the coupon amount) fixed over the life of the security, payable at six-monthly intervals. At maturity, investors are entitled to receive the face value of the security.

Exchange-traded Treasury Indexed Bonds (TIBs)

TIBs represent beneficial interests in medium- to long-term debt securities issued by the Australian Government for which the face value of the security is adjusted for movements in the Consumer Price Index (CPI). Interest is payable quarterly, at a fixed rate, on the adjusted capital value. At maturity, investors are entitled to receive the adjusted capital value of the security (i.e. the face value adjusted for movement in the CPI over the life of the bond).

1.1.4 Parties involved in Exchange-traded AGB transactions

The parties involved in an Exchange-traded AGB transaction are the holder, the Depository Nominee, the legal owner (Austraclear) and the Australian Government.

The holder

The holder purchases an Exchange-traded AGB (in the form of a CDI), which gives the holder a unit of beneficial interest in the beneficial ownership of the underlying AGB held by the Depository Nominee. One Exchange-traded AGB provides beneficial ownership of \$100 Face Value of the TB or TIB over which it has been issued. Owning an Exchange-traded AGB gives the holder the right to receive interest and principal payments due on the underlying AGB.

The Depository Nominee

CHESS Depository Nominees Pty Ltd is the entity appointed by the Australian Government under the ASX Settlement Operating Rules to hold beneficial title to an AGB that is, or is to be, held for the benefit of the holder of an Exchange-traded AGB in the form of a CDI.

The legal owner (Austraclear)

Austraclear is the ASX wholesale securities depository, which holds legal title to all AGBs.

The Australian Government

The Australian Government is the issuer of the underlying AGB and makes interest and principal payments due on the underlying AGB. Under payment instructions from Austraclear and the Depository Nominee, interest and principal payments due on the underlying AGBs are paid from the Australian Government to the holders of the Exchange-traded AGBs.

1.2 Types of holders

The income tax consequences of acquiring an Exchange-traded AGB may differ depending on whether the taxpayer trades in Exchange-traded AGBs, is merely speculating in Exchange-traded AGBs, or is investing long term in Exchange-traded AGBs.

Careful consideration should be given as to whether the holding of an Exchange-traded AGB should be treated as an investment or trading item as a particular transaction may have elements of more than one of the categories of trading, speculating or investing.

Care must also be taken when determining the tax treatment applicable to a type of holder of Exchange-traded AGBs as there may be other considerations, based on the specific facts and circumstances at hand, relevant in determining the income tax consequences of holding a particular Exchange-traded AGB.

1.2.1 Traders

A trader in Exchange-traded AGBs will be a person who carries on a business of routinely and systematically acquiring and disposing of Exchange-traded AGBs in the expectation of profit. Factors relevant in determining whether or not a taxpayer is a trader include:⁵

- Purpose of profit-making
- Repetition, regularity and frequency of trades and an intention to engage in trades routinely and systematically
- Turnover/volume of trades and the amount of capital employed
- Finance and lines of credit
- Evidence of a discernible system of trading (employing particular or sophisticated buying or selling strategies, preparation of contingency plans and preparation of budgets and targets)
- Operating in a business-like manner and the degree of sophistication involved
- The engagement of an adviser with professional skills
- Significant market research
- Operating to a plan, setting budgets and targets and keeping records
- Whether the taxpayer is engaged in another full-time profession and prior involvement in the industry or a related business occupation.

Ultimately, the question of whether a taxpayer is carrying on a business of trading is a question of fact and degree, without any particular factor being determinative.

1.2.2 Speculators

The difference between a speculator and a trader is somewhat blurry. A speculator may, for example, occasionally acquire Exchange-traded AGBs with the expectation of a profit. If a speculator is engaged in any business operation or commercial activity and acquires an Exchange-traded AGB in the course of carrying on that business or commercial activity, then any profit resulting from disposing of the Exchange-traded AGB will be income if the speculator had the intention, when entering into the transaction, of making a profit.⁶ Conversely, a deduction may be available to a speculator who acquires an Exchange-traded AGB if:

- (a) In entering into the transaction, the speculator intended or expected to derive a profit that would have been assessable income and
- (b) The transaction was entered into, and a loss was made, in the course of carrying on a business or in carrying out a business operation or commercial activity.⁷

1.2.3 Investors

For the purposes of this paper, an “investor” is assumed to invest in Exchange-traded AGBs on a long-term basis to derive interest income. Generally speaking, most individuals who acquire Exchange-traded AGBs outside the ordinary course of their business or employment are likely to be investors.

1.2.4 Superannuation funds

Superannuation funds holding Exchange-traded AGBs would generally be taken to invest in Exchange-traded AGBs. Whether or not a complying superannuation fund satisfies the trading criteria above, section 295-85 of the *Income tax Assessment Act 1997* (the 1997 Act) states that the CGT provisions generally apply to the disposal of an asset to the exclusion of the ordinary income tax provisions. However, the application of the CGT provisions does not apply in the case of certain CGT assets, including bonds. As Exchange-traded AGBs are interests in bonds, the taxation of Exchange-traded AGBs held by superannuation funds would generally be the same as for other investors.

1.2.5 Managed investment trusts (MITs)

MITs holding Exchange-traded AGBs would generally be taken to be investors in Exchange-traded AGBs.

Certain MITs can make an election to treat particular assets on capital account for tax purposes. Exchange-traded AGBs do not fit within the definition of assets that are covered by the capital election.⁸ An Exchange-traded AGB held by an MIT as an investment should be taxed in the same manner as for other investors, regardless of whether or not the MIT has made the capital election.

1.3 Nature of interest held

We have been advised that the nature of the relationships between both: (a) a holder of an Exchange-traded AGB and the Depository Nominee; and (b) the Depository Nominee and Austraclear is that of a bare trust. In regard to bare trusts, Treasury has stated that, “... widespread industry practice is to disregard bare trusts for Division 6 purposes. Tax practitioners treat the beneficiaries of such trusts as holding the trust assets and as being responsible for any tax responsibilities in respect of them. Trust income is returned by the beneficiaries directly – this means that they also claim losses.”⁹

The tax consequences outlined in this paper are based, firstly, on our understanding that the nature of the relationships between the relevant parties is that of bare trusts and, secondly, on the industry practice noted above (i.e. that all gains and losses flow through to the holder of the TB or TIB). However, holders should be aware that the ATO may take an alternative view, which may result in different taxation consequences to those outlined in the paper (particularly for losses on Exchange-traded AGBs or the taxation of Exchange-traded AGBs held by persons under a legal disability or held jointly).

Each holder should refer to the Information Statement issued by the Australian Government and seek their own professional advice on the nature of their interest in a TB or TIB and the taxation implications for their specific circumstances.

2 Income tax treatment of Exchange-traded AGBs

2.1 Overview of taxation provisions

2.1.1 Taxation of Financial Arrangements

Specific tax rules for the Taxation of Financial Arrangements (TOFA) contained in Division 230 of the 1997 Act may apply to certain taxpayers holding Exchange-traded AGBs. Consistent with the industry practice outlined at 1.3 above (such that the bare trust relationships are effectively disregarded), it is arguable that TOFA should be applied as if the holder holds the underlying AGBs directly.

TOFA should not apply to the following taxpayers, unless those taxpayers irrevocably elect for TOFA to apply to all financial arrangements entered into by the taxpayer:

- Individuals
- Superannuation entities, managed investment schemes, or similar entities under a foreign law with assets less than \$100 million in value
- ADIs, securitisation vehicles or entities registered under the *Financial Sector (Collection of Data) Act 2001* with aggregated turnover of less than \$20 million per annum
- Any other entity with aggregated turnover of less than \$100 million per annum, financial assets of less than \$100 million in value and total assets of less than \$300 million in value.

The above taxpayers who *prima facie* fall outside TOFA may still fall within TOFA, however, if the financial arrangement ends more than 12 months from when it is entered into and is a 'qualifying security' (a qualifying security is a security where it is reasonably likely, at the time it is issued, that the payments under the security (excluding periodic interest) will exceed the issue price of the security).¹⁰ This is unlikely to apply to TBs as the face value will be repaid on maturity of a TB. As TIBs are capital indexed based on the CPI, they are likely to constitute 'qualifying securities'. Therefore, TIBs are likely to be subject to TOFA if they have more than 12 months to maturity from the time that an investor acquires the TIB.

If the TOFA rules do apply to a taxpayer, various irrevocable elections can be made by a taxpayer under those rules. As the elections made by a taxpayer will depend upon the circumstances of that taxpayer, this paper does not cover the elective methods. This paper does, however, broadly set out what should be the result under the 'default methods'. Even the application of the default methods will depend, however, on the specific circumstances of the taxpayer. Holders of Exchange-traded AGBs should seek their own professional advice on the application, if any, of TOFA in their unique circumstances.

2.1.2 Trading stock

There are specific provisions contained in Division 70 of the 1997 Act which apply to the tax treatment of trading stock. Division 70 defines 'trading stock' as including, "anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange..."¹¹

The ordinary meaning of trading stock is something that is acquired by a trader and held for resale (i.e., the nature of the business is to buy and sell 'things'). As Exchange-traded AGBs may be sold, they may fall within the meaning of trading stock and so the trading stock provisions may apply to traders buying and selling Exchange-traded AGBs.

Under the trading stock provisions, gross outgoings and receipts are taxed on revenue account, with gross outgoings usually deductible as general deductions and gross receipts usually assessable as ordinary income.¹²

In addition, the difference in value of trading stock on hand at the start and end of the income year is included in assessable income or as a deduction (some concessions may apply for small business entities). The value of trading stock on hand should be worked out using one of the methods set out in the trading stock provisions. Holders of Exchange-traded AGBs should seek their own professional advice as to the application of the trading stock provisions.

2.1.3 Traditional securities

Generally, gains on the disposal or redemption of traditional securities are assessable income under section 26BB of the 1936 Act, while losses are deductible against assessable income under section 70B of the 1936 Act.

A "traditional security" is defined at section 26BB of the 1936 Act. Broadly, a traditional security is a security that is not issued at a discount of more than 1.5% per annum, does not bear deferred interest and is not capital indexed. A "security" is defined to include "a secured or unsecured loan".¹³

TBs should generally qualify as traditional securities as they satisfy the requirements outlined above, unless the TBs are held as trading stock.¹⁴

2.1.4 Qualifying securities

The qualifying security provisions in Division 16E of the 1936 Act apply to taxpayers who are not subject to TOFA that hold qualifying securities for all or part of an income year. A qualifying security is defined as a security where it is reasonably likely, at the time it is issued, that the payments under the security (excluding periodic interest) will exceed the issue price of the security.

The provisions of Division 16E require holders of qualifying securities to include an amount of assessable income or a deduction in their taxable income over the term of the qualifying security.¹⁵

TIBs are likely to be qualifying securities as the capital amount of TIBs is CPI-indexed. If TIBs have 12 months or less to maturity from the time that an investor acquires the TIB, the TIBs will be taxed under the qualifying securities provisions. Conversely, if TIBs have more than 12 months to maturity from the time that an investor acquires the TIB, the TIBs are likely to be taxed under the TOFA provisions.

No amounts are required to be included in taxable income under the qualifying securities provisions where TIBs are held as trading stock.¹⁶

2.2 Income tax treatment of TBs

2.2.1 Taxation where TOFA applies

TOFA may mandatorily apply where a holder of TBs meets the thresholds outlined in the 'Taxation of Financial Arrangements' section above. If the thresholds do not apply, a holder may still irrevocably elect for TOFA to apply to all of their financial arrangements.

If TOFA applies, the TBs will be taxed under the TOFA provisions regardless of whether the holder is a trader or an investor. The TOFA provisions generally treat all gains and losses from financial arrangements as being on revenue account. Because the face value of TBs is payable in cash on maturity, they are "cash settleable" obligations for the purposes of the TOFA provisions and will be financial arrangements for TOFA.¹⁷

Generally, TBs should have outcomes which are sufficiently certain (i.e. fixed interest and repayment of face value on maturity) so that the overall gain or loss would be fixed or determinable with reasonable accuracy at the time the holder acquires the TB. As a result, the accruals method should apply to the gains or losses on TBs under TOFA.¹⁸

Broadly, the accruals method applies to spread the overall gain or loss over the life of the financial arrangement, assuming the TB will be held until maturity.¹⁹ The overall gain or loss is to be spread using the compounding accruals method or a method which approximates the compounding accruals method. Holders of TBs where TOFA applies are advised to seek their own professional advice on the application of TOFA based on their individual circumstances.

Taxation over the life of the TB

The overall gain or loss expected to arise over the life of the TB (including interest and any difference between the purchase price and the maturity value) should be brought to account under TOFA on an accruals basis.

Taxation at maturity/upon sale

Holders of TBs may choose to hold a TB to maturity or dispose of the TB prior to the maturity date. For TBs held to maturity, any gain or loss on maturity should be the amount determined using the accruals method under TOFA.

As TBs are tradeable on the ASX, a payment received upon sale may result in a different overall gain or loss than the accrual amounts previously brought to account under TOFA. A balancing adjustment should be included in the holder's assessable income or allowable deductions upon disposal of TBs to account for the difference between the overall gain or loss realised on disposal and the amounts previously brought to account under TOFA.²⁰

Example 1 – Holding TBs to maturity where TOFA applies

On 26 May 2013, a holder (who is subject to TOFA) purchases 1,000 Exchange-traded TBs with the following characteristics:

Coupon	6%
Coupon frequency	Six monthly on 15 February and 15 August
Maturity date	15 February 2019
Face value	\$100
Market price	\$108.17

- 1. The holder of the TBs will be required to account for the overall gain on the arrangement over the life of the arrangement.*

The overall gain is worked out as follows:

$$\begin{aligned} & \text{Payment at maturity} + (\text{interest amount} \times \text{number of payments made}) - \\ & \text{purchase price} \\ & = \$100,000 + (\$3,000 \times 12) - \$108,170 \\ & = \$27,830 \end{aligned}$$

2. The overall gain of \$27,830 is allocated to income tax years over the life of the arrangement using a compounding accruals method.

2.2.2 Taxation where TOFA does not apply

Where TOFA does not apply, TBs would generally be taxed under the trading stock provisions for holders who are treated as trading in TBs or the traditional security provisions for other holders of TBs.

Taxation over the life of the TB

Interest received over the life of the TB should generally be assessable on a due and receivable basis for all holders of TBs which are not subject to TOFA.

A trader who buys a TB will generally be taxed under the trading stock provisions outlined in the 'Trading stock' section above. As such, a trader should be able to claim a general tax deduction for gross outgoings incurred on acquisition of TBs at the time the amounts paid to acquire the TB become due and payable.

As outlined in the 'Trading stock' section above, a trader in TBs will also need to include the value of trading stock on hand in working out assessable income and deductions.

Taxation at maturity/upon sale

Traders

Under the trading stock provisions, any gross earnings derived from selling TBs should be assessable as ordinary income (i.e. when the proceeds are due and receivable upon sale or maturity, with a deduction allowed for the last tax value or purchase price, as applicable).

Example 2 – Trader holding TB to maturity and TOFA does not apply

On 26 May 2013, a trader (who is not subject to TOFA) buys 1,000 Exchange-traded TBs with the following characteristics. The Exchange-traded TBs constitute trading stock to the trader.

Coupon	6%
Coupon frequency	Six monthly on 15 February and 15 August
Maturity date	15 February 2019
Face value	\$100
Market price	\$108.17

1. The trader is able to deduct the purchase price of \$108,170 in the 2013 income year. If the Exchange-traded TBs are held at the end of the 2013 income year, an assessable amount equal to their tax value is included in assessable income. This amount is then deducted in the 2014 income year. Similar adjustments are made in subsequent years until the Exchange-traded TBs are sold or mature.
2. A coupon of 6% per annum is paid twice per year.

The income is calculated as follows:

$(\text{Number of Exchange-traded TBs} \times \text{face value}) \times (\text{coupon rate}/\text{coupon frequency})$

$= (1,000 \times \$100) \times (0.06/2)$

$= \$3,000$ every six months

The trader is assessed on the interest receipts (including the final coupon payment) when they are due and receivable.

3. The \$100,000 face value received on maturity is an assessable amount to the trader in the year the TB matures, with a deduction allowed for the last tax value or purchase price (as applicable).

Similar treatment would apply to a trader in TIBs where TOFA does not apply.

Other holders (including superannuation funds and MITs)

Other holders of TBs (including superannuation funds and MITs) should be taxed on gains or losses arising on the disposal or maturity of TBs under the traditional security provisions.

Under the traditional security provisions, when the TB is sold or matures, the difference between the amount paid by the holder for the TB and the amount received by the holder upon the sale or maturity of the TB should be treated as an assessable gain or deductible loss for the holder.

Example 3 – Investor holding to maturity and TOFA does not apply

On 26 May 2013, an investor (who is not subject to TOFA) purchases 1,000 Exchange-traded TBs with the following characteristics:

Coupon	6%
Coupon frequency	Six monthly on 15 February and 15 August
Maturity date	15 February 2019
Face value	\$100
Market price	\$99.50

1. The purchase price will not be deductible to the investor, but is later used to determine whether a gain or loss has been made.
2. Interest will be assessable as ordinary income to the investor when it is due and receivable.
3. Upon maturity, the investor will receive the face value of the Exchange-traded TBs and the final coupon, calculated as follows:

$[(\text{Number of Exchange-traded TBs} \times \text{face value}) \times (\text{coupon rate}/\text{coupon frequency})] + (\text{number of Exchange-traded TBs} \times \text{face value})$

$= [(1,000 \times \$100) \times (0.06/2)] + (1,000 \times \$100)$

$= \$3,000 + \$100,000$

4. The final coupon of \$3,000 is assessable as ordinary income to the investor.
5. The original purchase price is subtracted from the face value received on maturity, and the investor makes an assessable gain, as follows:

Proceeds received - Original purchase price of Exchange-traded TBs

$= (1,000 \times \$100) - (1,000 \times \$99.50)$

$= \$100,000 - \$99,500$

$= \$500$

Example 4 – Sale before maturity and TOFA does not apply

On 26 May 2013, an investor (who is not subject to TOFA) purchases 1,000 Exchange-traded TBs, using the same facts as Example 3 (above).

The investor sells the 1,000 Exchange-traded TBs on 26 May 2014 (before maturity), for an amount of \$110,000.

1. The purchase price will not be deductible to the investor, but is later used to determine whether a gain or loss has been made.
2. A coupon of 6% per annum is paid twice per year. The income is calculated as follows:

(Number of Exchange-traded TBs x face value) x (coupon rate/coupon frequency)

= (1,000 x \$100) x (0.06/2)

= \$3,000 every six months

This interest will be assessable as ordinary income to the investor when it is due and receivable.

3. On sale of the Exchange-traded TBs, the investor makes an assessable gain as follows:

Proceeds received – purchase price of Exchange-traded TBs

= \$110,000 - \$99,500

= \$10,500

2.3 Income tax treatment of TIBs

2.3.1 Taxation where TOFA applies

As with the taxation of TBs, TOFA may mandatorily apply where a holder of TIBs meets the thresholds outlined in the 'Taxation of Financial Arrangements' section above. If the thresholds do not apply, a holder may still irrevocably elect for TOFA to apply to all of their financial arrangements. In addition, a TIB that matures more than 12 months after it is acquired by a holder will be mandatorily subject to TOFA.

Where TOFA applies, the TIB will be taxed under the TOFA provisions regardless of whether the holder is trading or investing in the TIB.

The TOFA provisions generally treat all gains and losses from financial arrangements as being on revenue account. Because the adjusted capital value of TIBs is payable in cash on maturity, TIBs are "cash settleable" rights to receive a financial benefit for the purposes of the TOFA provisions and the TIBs will be financial arrangements under TOFA.²¹

Generally, TIBs should have outcomes which are sufficiently certain (i.e. fixed interest and repayment of the adjusted capital value on maturity) so that the overall gain or loss would be fixed or determinable with reasonable accuracy at the time the holder acquires the TIB. As a result, the accruals method should apply to the gains or losses on TIBs under TOFA.

Broadly, the accruals method applies to spread the overall gain or loss over the life of the financial arrangement, assuming the TIB will be held until maturity.²² The overall gain or loss is to be spread using the compounding accruals method or a method which approximates the compounding accruals method. Holders of TIBs where TOFA applies are advised to seek their own professional advice on the application of TOFA based on their circumstances.

Taxation over the life of the TIB

The overall gain or loss expected to arise over the life of the TIB (including interest and any expected gain or loss on maturity) should be brought to account under TOFA on an accruals basis. In determining the accrual amount, it should be assumed that the CPI rate at the time of acquisition remains the same throughout the remainder of the life of the TIB.²³

An adjustment may be required where the amount accrued in an income year for interest on a TIB is different to the amount of the actual interest received during the income year based on the adjusted capital value of the TIB. Any adjustment required should be included in the holder's assessable income or allowable deductions in the income year in which the interest receipt is received.²⁴

Taxation at maturity/upon sale

Holders of TIBs may choose to hold a TIB to maturity or to dispose of it prior to the maturity date. For TIBs held to maturity, the holders are entitled to receive payment on maturity adjusted for the actual movement in CPI over the life of the bond. This payment may result in a different overall gain or loss from the amount accrued under TOFA (which assumes the CPI remains the same throughout the life of the bond).

For TIBs sold on the ASX, amounts received upon disposal may also result in a different overall gain or loss than that previously brought to account under TOFA.

A balancing adjustment should be included in the holder's assessable income or allowable deductions upon maturity or disposal of TIBs to account for the difference between the overall gain or loss realised on maturity or disposal and the amounts previously brought to account under TOFA.

Example 5 – TIBs held to maturity, TOFA applies

On 26 May 2013, a holder buys 1,000 Exchange-traded TIBs with the following characteristics:

Coupon	6%
Coupon frequency	Quarterly on 15 February, 15 May, 15 August and 15 November
Maturity date	15 February 2019
Face value	\$100 + CPI*
Market price	\$108.17

*Example assumes the CPI is 2% at the time of acquisition.

1. The holder of the TIBs will be required to account for the overall gain on the arrangement over the life of the arrangement. In determining the overall gain, the investor assumes that the CPI will continue to be a rate of 2% compounding and that the Exchange-traded TIB will be held to maturity.
2. The overall gain is allocated to income tax years over the life of the arrangement using a compounding accruals method.
3. Running balance adjustments (made at the time of each interest receipt) will be assessable or deductible where the actual CPI adjustment is more or less than 2%.

2.3.2 Taxation where TOFA does not apply

Where TOFA does not apply because the TIB matures no more than 12 months after the holder acquires it, gains and losses on TIBs will be taxed under the trading stock provisions for holders who are treated as trading in TIBs, or under the qualifying security provisions for other holders of TIBs.

Taxation over the life of the TIB

Traders

Interest received over the life of the TIB should generally be assessable on a due and receivable basis for traders in TIBs which are not subject to TOFA.

A trader who buys a TIB will generally be taxed under the trading stock provisions outlined in the 'Trading stock' section above. As such, a trader should be able to claim a general tax deduction for gross outgoings incurred on acquisition of TIBs at the time the amounts paid to acquire the TIB become due and payable.

As outlined in the 'Trading stock' section above, a trader in TIBs will also need to include the value of trading stock on hand in working out assessable income and deductions.

Other holders (including superannuation funds and MITs)

Interest received over the life of the TIB should also generally be assessable on a due and receivable basis for other holders in TIBs which are not subject to TOFA.²⁵

In addition, an accrual amount should be determined under the qualifying security provisions each six months using an implicit interest rate calculated by reference to the difference between the issue price of the TIB and its maturity value. The maturity value is determined assuming that the CPI rate at the time of acquisition remains the same throughout the remainder of the life of the TIB. The accrual amount for each six-month period should be included in assessable income or as a deduction for the holder of the TIB. As the calculation of an accrual amount under Division 16E can be complex, holders that acquire a TIB which matures no more than 12 months after the holder acquires it should seek specific tax advice.

Taxation at maturity/upon sale

Traders

Under the trading stock provisions, any gross earnings derived from selling TIBs should be taxable as ordinary income (i.e. when the proceeds are due and receivable upon sale or maturity, with a deduction allowed for the last tax value or purchase price, as applicable).

Other holders (including superannuation funds and MITs)

Holders of TIBs may choose to hold a TIB to maturity or to dispose of it prior to the maturity date. A balancing adjustment should be included in assessable income or as an allowable deduction upon maturity or disposal of the TIB. The balancing adjustment is calculated as the difference between: (a) the gain or loss realised on maturity or disposal; and (b) the accrual amounts previously included in assessable income or as an allowable deduction for the period(s) the TIB was held by the investor.²⁶

If the TIB is acquired and sold or matures within an income tax year, the gain or loss should be the difference between the acquisition price and the sale price or amount received on maturity of the TIB (apart from any interest receipts, which would also be assessable to the investor).

3 Summary of realisation of profits or losses

3.1 Taxation where TOFA applies

	Interest	Gain/loss on maturity/sale
TB	Interest is accrued over the period from acquisition to maturity.	The difference between the acquisition price and the face value is accrued over the period from acquisition to maturity. A balancing adjustment may be required upon sale for the difference between the actual gain/loss and the accrued amount.
TIB	Interest is accrued over the period from acquisition to maturity. A balancing adjustment may be required upon receipt of interest for the difference between the interest received and the accrued amounts.	The difference between the acquisition price and the estimated maturity amount based upon the CPI continuing at the CPI rate when the TIB was acquired is accrued over the period from acquisition to maturity. A balancing adjustment may be required upon sale or maturity for the difference between the actual gain/loss and the accrued amounts.

3.2 Taxation where TOFA does not apply and holder is not a trader

	Interest	Gain/loss on maturity/sale
TB	Interest is included as assessable income when due and receivable.	The difference between the acquisition price and the face value is an assessable gain or deductible loss when the TB matures or is sold.
TIB	<u>TIB acquired with more than 12 months to maturity</u> TOFA applies to the TIB – refer above.	<u>TIB acquired with more than 12 months to maturity</u> TOFA applies to the TIB – refer above.
	<u>TIB acquired with 12 months or less to maturity</u> Interest is included as assessable income when due and receivable.	<u>TIB acquired with 12 months or less to maturity</u> An accrual amount is determined every six months using an implicit interest rate. A balancing adjustment may be required upon sale or maturity for the difference between the actual gain/loss and the accrued amounts.

3.3 Taxation where TOFA does not apply and holder is a trader

	Interest	Gain/loss on maturity/sale
TB	Interest is included as assessable income when due and receivable.	<p>The difference between the acquisition price or prior year end value and the face value (or sale proceeds) is an assessable gain or deductible loss when the TB matures (or is sold).</p> <p>In addition, where a TB is held at the end of an income year, the difference in value of trading stock on hand at the start and end of the income year is included in assessable income or as a deduction (some concessions may apply for small business entities).</p>
TIB	<p><u>TIB acquired with more than 12 months to maturity</u></p> <p>TOFA applies to the TIB – refer above.</p>	<p><u>TIB acquired with more than 12 months to maturity</u></p> <p>TOFA applies to the TIB – refer above.</p>
	<p><u>TIB acquired with 12 months or less to maturity</u></p> <p>Interest is included as assessable income when due and receivable.</p>	<p><u>TIB acquired with 12 months or less to maturity</u></p> <p>The difference between the acquisition price or prior year end value and the maturity value (or sale proceeds) is an assessable gain or deductible loss when the TIB matures (or is sold).</p> <p>In addition, where a TIB is held at the end of an income year the difference in value of trading stock on hand at the start and end of the income year is included in assessable income or as a deduction (some concessions may apply for small business entities).</p>

4 Concluding comments

4.1 Calculation of accrual amounts

If TOFA or Division 16E applies, an accrual amount is required to be calculated. The tax legislation contains a number of provisions that outline how the accrual amount is to be calculated (e.g. assuming that a variable factor such as the CPI rate remains the same from when the financial arrangement or qualifying security is acquired until maturity). Accordingly, taxpayers should seek their own professional advice, taking into account their specific circumstances, to determine any accrual amounts that should be included in their assessable income or allowable deductions.

4.2 Trading, speculating or investing

The income tax consequences of acquiring Exchange-traded AGBs can depend on whether the taxpayer is trading in Exchange-traded AGBs, is merely speculating in Exchange-traded AGBs, or is investing in Exchange-traded AGBs over a longer term. The appropriate characterisation may sometimes be difficult to determine. Relevant factors include the taxpayer's purpose in acquiring the Exchange-traded AGB, whether the taxpayer is involved in business or commerce, the taxpayer's overall activities and the place the particular transaction has in relation to those activities, and the economic nature and value of the transaction (which may be determined, for example, by reference to the relevant cash flows).

4.3 Borrowing costs and Exchange-traded AGBs

Where a taxpayer borrows funds in a business that involves trading in Exchange-traded AGBs to produce assessable income, interest expenses should be deductible as an ordinary business outgoing.

4.4 TOFA

The TOFA provisions are principle-based and so different outcomes can arise for different taxpayers, depending on their particular circumstances. It is sometimes difficult to draw conclusions about the general application of these rules to taxpayers. The TOFA provisions are also still relatively new and introduce concepts that have not previously been tested by the courts.

Accordingly, taxpayers should seek their own professional advice, taking into account their specific circumstances, about the potential application of TOFA, particularly if they do not fall within one of the groups excluded from the provisions (e.g. an entity that exceeds the financial thresholds or a TIB acquired with more than 12 months to maturity).

4.5 Tax reform

This paper is based on the taxation law as at January 2013. A number of amendments to the tax laws have been announced but not yet enacted and consultation is underway on reforms to other taxation areas (e.g. aspects of the TOFA provisions, taxation of trusts). If there are any significant changes to the taxation laws, or the interpretation of the taxation laws by the courts or the Australian Taxation Office, such changes may result in changes to the taxation treatment of Exchange-traded AGBs. Accordingly, taxpayers should stay informed about any relevant changes to the taxation laws.

Endnotes

¹ This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the “Deloitte Network”) is, by means of this publication, rendering professional advice or services.

Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

Tax agent services are provided by Deloitte registered tax agent entities.

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/au/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte has in the region of 200,000 professionals, all committed to becoming the standard of excellence.

About Deloitte Australia

In Australia, the member firm is the Australian partnership of Deloitte Touche Tohmatsu. As one of Australia’s leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, and financial advisory services through approximately 6,000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit Deloitte’s web site at www.deloitte.com.au.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Touche Tohmatsu Limited

© Deloitte Tax Services Pty Ltd, March 2013

² Commonwealth Government Securities Legislation Amendment (Retail Trading) Act 2012

³ ASX, ‘Exchange-traded Australian Government Bonds’, 2012

⁴ ASX, ‘Understanding CHES Depository Interests’, 2012

⁵ These factors have been developed from a number of cases, such as *FCT v Radnor (1991) 102 ALR 187*, *Shields v Deputy FCT (1991) 41 ATR 1042*. The factors were recently applied in *Smith and Commissioner of Taxation [2010] AATA 576*.

⁶ See Taxation Ruling TR 92/3 – Whether profits on isolated transactions are income and ATO ID 2001/23

⁷ See Taxation Ruling TR 92/4 – Whether losses on isolated transactions are deductible

⁸ Section 275-105 of the 1997 Act defines “covered assets” as a share in a company, a non-share equity interest in a company, a unit in a unit trust, land and a right or option to acquire such assets, unless the asset is a debt interest or a financial arrangement under TOFA.

⁹ Commonwealth of Australia, *Taxing trust income – options for reform*, October 2012 p. 28

¹⁰ Section 159GP(3) of the 1936 Act

¹¹ Section 70-10 of the 1997 Act

¹² Section 70-5 of the 1997 Act

¹³ Section 159GP(1) of the 1936 Act

¹⁴ Section 26BB(1) of the 1936 Act

¹⁵ Section 159GQ of the 1936 Act

¹⁶ Section 159GY of the 1936 Act

¹⁷ Section 230-45 of the 1997 Act defines a financial arrangement as a “cash settleable” legal or equitable right to receive or obligation to provide a financial benefit. “Cash settleable” is defined in subsection 230-45(2) and includes a benefit that is money or money equivalent. The payment of the face value of the TBs or the capital adjusted value of the TIBs upon maturity is money or money equivalent and, accordingly, the TBs and TIBs are financial arrangements for the purposes of TOFA.

¹⁸ Section 230-100(2) of the 1997 Act

¹⁹ Section 230-135(7) of the 1997 Act

²⁰ Section 230-455 of the 1997 Act

²¹ Refer to note 17 above.

²² Section 230-135(7) of the 1997 Act

²³ Section 230-115(4) and (5) of the 1997 Act

²⁴ Section 230-175 of the 1997 Act

²⁵ Interest on the TIB is determined using a fixed rate applied to the adjusted capital value of the TIB. As such, it should qualify as periodic interest for the purposes Division 16E of the 1936 Act as considered by the Commissioner in Taxation Ruling TR 96/3 Income Tax: ‘periodic interest’ in Division 16E of the Income Tax Assessment Act 1936 (refer to paragraph 23). Periodic interest is not included in the calculation of the Division 16E accrual amount and is taxed under the ordinary income tax provisions.

²⁶ Section 159GS of the 1936 Act