TD 2004/D88 - Income tax: section 8-1 of the Income Tax Assessment Act 1997 : capital protected loan facility with a trading feature: interest deductibility

This document has been finalised by TD 2005/6.

Draft Taxation Determination

Income tax: section 8-1 of the *Income Tax Assessment Act 1997*: capital protected loan facility with a trading feature: interest deductibility

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

On 16 April 2003 the Treasurer announced amendments to the Income Tax Assessment Act 1997 to ensure part of the expense of a capital protected product is attributed to the cost of the capital protection feature. The expense is apportioned in accordance with the guidelines (interim methodology) announced by the Minister for Revenue and Assistant Treasurer on 30 May 2003 in the press release 'Taxation of Capital Protected Products'.

This Taxation Determination relates to that part of the interest expense that is available for a deduction in accordance with the interim methodology and is referred to in this Taxation Determination as 'Interest'.

Background

1. A capital protected loan facility is a fixed term loan used to purchase shares listed on the Australian Stock Exchange. Typically, a capital protected loan will either be a limited recourse loan or a full recourse loan together with a put option. The capital protected feature means that the investor is effectively protected from the risk of a fall in the price of the shares as the associated put option enables the borrower to require the lender to take the shares in full repayment of the borrowed sum.

2. Interest is payable on the capital protected loan facility. Typically interest will either be payable annually in advance or monthly in arrears.

3. Under a capital protected loan facility the investor may have the opportunity to use a '*trading feature*'. A trading feature allows an investor to sell the underlying shares without terminating the loan facility. Generally, the proceeds from sale of the shares are placed in an income producing security deposit account until such time as the investor acquires further shares.

4. An investor may use the proceeds of sale to re-acquire either the same number and kind of shares originally held in a company or companies or to acquire shares in a different company or companies with a value equal to the original loan amount. Where the proceeds of sale of the original shares are greater than the amount used to acquire further shares, the investor is able to withdraw the surplus amount from the security deposit account. Where the proceeds of sale are less than the amount used to acquire further shares, the investor must contribute the amount of the shortfall.

5. If the investor elects to re-acquire the same number and kind of shares originally held, the terms of the capital protected loan will remain the same, albeit that the loan amount may change. If the investor elects to acquire different shares equal in value to the amount of the loan, the original put option will generally be terminated and a new put option is granted in respect of the newly acquired shares.

Determination

Drawdown of the capital protected loan facility

6. When the capital protected loan is first drawn down and the proceeds are used to acquire shares that are expected to produce dividends, the necessary nexus with the assessable income exists for the Interest outgoings to be deductible under section 8-1 of the *Income Tax Assessment Act 1997*.

Trading shares

7. Where an investor subsequently sells the shares as a result of using the trading feature it is necessary to determine whether the occasion of the Interest outgoing continues to be found in an income producing activity. The application of the proceeds of sale equivalent to the original loan amount to another income producing purpose will demonstrate the necessary connection between the Interest outgoings and a continuing income producing activity.

8. Accordingly, where proceeds equivalent to the original loan amount are used to acquire further shares or remain in an income producing security deposit account, there is no relevant change in the income producing purpose and the connection between the Interest outgoing and the income producing activity continues. Consequently, the Interest outgoings will continue to be deductible under section 8-1.

9. Where the use of the borrowed funds has changed and they are no longer used for income producing purposes, Interest on the loan ceases to be deductible.

10. Should the capital protected loan arrangements allow proceeds to be withdrawn from the facility such that the amount reinvested in shares or in an income producing security deposit account is less than the amount borrowed, there is a change in the use of the funds to that extent. Consequently, the Interest outgoings will need to be apportioned.

Note 1: *Acquisition of the shares on capital account will not necessarily mean that a subsequent disposal is on capital account. This will depend on the facts and circumstances relevant to each investor.*

Note 2: *Where interest is paid in advance the prepayment provisions in Subdivision H of Division 3 Part III of the Income Tax Assessment Act 1936 will need to be considered.*

Date of Effect

11. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

12. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

Due date:	**18 February 2005**
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Commissioner of Taxation
22 December 2004

Previous draft:
Not previously issued in draft form.

Related Rulings/Determinations:
TR 92/20

Subject references:
- capital protected loan facility
- capital protected product
- interest deductibility
- limited recourse loan
- trading feature

Legislative references:
- TAA 1953 Part IVAAA
- ITAA 1997 8-1
- ITAA 1936 Part III Div 3 Subdiv H

ATO references
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