

# ***PR 2000/70 - Income tax: deductibility of interest incurred on borrowings under the Macquarie Geared Equities Investment Facility***

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 This document has changed over time. This is a consolidated version of the ruling which was published on 7 June 2000



## **Product Ruling**

### Income tax: deductibility of interest incurred on borrowings under the Macquarie Geared Equities Investment Facility

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Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

#### **Preamble**

*The number, subject heading, and the **What this Product Ruling is about (including Tax law(s), Class of persons and Qualifications sections), Date of effect, Withdrawal, Previous Rulings, Arrangement and Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and 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.*

## **No guarantee of commercial success**

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

## **Terms of Use of this Product Ruling**

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

## What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of person who takes part in the arrangement to which this Ruling relates. In this Ruling the arrangement is the borrowing of moneys from Macquarie Bank Limited ('the Bank') to fund investments in the Macquarie Geared Equities Investment which is referred to in this Ruling as 'the GEI'.

### Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 8-1 of the *Income Tax Assessment Act 1997* ('the 1997 Act');
- section 51AAA of the *Income Tax Assessment Act 1936* ('the 1936 Act');
- section 82KL of the 1936 Act
- section 82KZM of the 1936 Act;
- sections 82KZMA to 82KZMC of the 1936 Act; and
- Part IVA of the 1936 Act.

3. On 11 November 1999, the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters', could affect the tax laws dealt with in this Ruling. Some of the changes apply from the date of announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant laws are enacted.

5. However, if the changes become law, the operation of that law will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the ruling based on the information contained and the advice given in this Ruling.

### Class of persons

6. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of deriving assessable

income from their involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'investors'.

### **Qualifications**

7. The Commissioner rules on the precise arrangement identified in the Ruling.

8. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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### **Date of effect**

10. This Ruling applies from 7 June 2000. However, the Ruling does 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 Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

11. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

### **Previous Rulings**

12. This Ruling replaces Product Ruling PR 2000/6, which is withdrawn on and from the date this Ruling is made. Product Ruling

2000/6 will continue to apply to investors who entered into the Project on or before 7 June 2000.

## **Withdrawal**

13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

## **Arrangement**

14. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- Application for a Product Ruling dated 4 May 2000, received from Baker & McKenzie on behalf of Macquarie Bank Limited; and
- The Macquarie Geared Equities Investment Brochure, Application for Finance Form and Loan and Security Agreement including amendments to clauses 24 and 27 of that Agreement in respect to the blocked non-interest bearing deposit account.

15. The details of the aspects of the arrangement subject to this Ruling are summarised as follows:

- (a) Under the GEI, the investor borrows funds from the Bank to finance the purchase of certain shares in the investor's name.
- (b) The investors are required to select shares to the value of their investment from a list of publicly listed shares which is provided with the GEI application form. The minimum loan amount is \$50,000.
- (c) The term of the loan is three or five years. Interest on an investment in the GEI with a fixed rate is payable annually in advance in May or June only. Alternatively investors can choose to pay the interest monthly in arrears at a variable rate.

(d) The rate of interest charged by the Bank to customers borrowing under the GEI varies according to the term of the loan, with the shorter the period of the loan and the more volatile the price of shares, the higher the rate of interest charged. Investors can choose from a fixed or variable interest rate. At present the interest rate can vary from around 15% p.a. for a five year term to around 17% p.a. for a three year term.

(e) A share brokerage fee and stamp duty will apply whenever the investor purchases or sells shares. Financial Institutions Duty (FID) is also payable on the loan repayment.

(f) For the purposes of securing the rights of the Bank under the GEI, the investor shall deal with the shares as the Bank may specify (clause 22). Limited trades on shareholdings are subject to the Bank's consent (clause 24). Any proceeds from the sale of shares are to be held in a blocked non-interest bearing account until the termination of the GEI or repurchase of the shares.

(g) There may also be costs associated with an early unwind of the facility.

(h) Clause 23 of the GEI Agreement provides for a limited recourse facility. As such, the Bank is only entitled to enforce its rights as mortgagee in relation to the principal of the loan against the shares held as security. If, when the loan matures, the price of the shares purchased with the loan proceeds is below the original cost of those shares, the investor may give notice that it will not repay the whole (or any part) of the loan, but will require the Bank to exercise its rights as mortgagee of the shares. As such, the investor is never required to repay the difference between the market value of the shares and the principal borrowed. Due to the limited recourse nature of the loan, the rates of interest payable on the loan tend to be high when compared to more traditional lending facilities.

(i) Upon maturity of the loan, investors may;

- (i) repay the loan in full using cleared funds;
- (ii) release particular parcels of the shares to the Bank in lieu of part payment of the loan and repay the balance with cleared funds;
- (iii) sell all or particular parcels of shares; or
- (iv) roll the loan over for another term.

- (j) If the value of the shares at maturity of the loan is greater than the principal borrowed, the investor will, after the payment of the facility fee, make a profit.
- (k) Any dividends paid in respect of the shares purchased under the GEI are paid to the investor.
- (l) The investor receives the benefit of any rebates or credits attaching to any dividends received subject to the at-risk holding period rules applying generally to shares acquired after 1 July 1997.
- (m) Any dividends paid during the period of the loan and reinvested as part of a Dividend Reinvestment Plan will be retained by the investor at the expiry of the loan.
- (n) Bonus shares issued will be held by the Bank on the investor's behalf and will form part of the security for the GEI. At the expiry of the loan, should the market value of the original shares and any bonus shares be below the cost of the original parcel of shares, both the original and bonus shares will be released to the Bank.

## **The Participants**

16. The Bank is the provider of loans under the GEI to investors to fund the acquisition of a portfolio of approved shares.

17. The majority of investors will be individuals. There will also be investors using companies or trusts to make an investment in the GEI.

## **Ruling**

18. Subject to the assumptions listed in paragraph 19 of this Ruling:

- (a) Part of the 'interest' charged under the GEI is a capital protection fee and is not deductible under section 8-1 of the 1997 Act.
- (b) The GEI interest charge allowable under section 8-1 is the amount that does not exceed the benchmark interest rates calculated as the average between the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans and Credit Cards. The ATO has released the benchmark interest rates that govern the amount of interest that an investor is permitted to claim

in respect of capital protected equity products such as the GEI.

- (c) Section 51AAA of the 1936 Act will not apply to deny the GEI interest charge allowable under section 8-1.
- (d) Section 82KL, a specific anti-avoidance provision of the 1936 Act, will not apply to deny deductibility of the GEI interest charge allowable under section 8-1.
- (e) Section 82KZM of Subdivision H of Division 3 of Part III of the 1936 Act will not apply to deny deductibility of any part of the GEI fixed interest charge allowable under section 8-1 where the investor prepays the interest and is a small business taxpayer, or where the investor does not incur the expenditure in carrying on a business.
- (f) Sections 82KZMA, 82KZMB and 82KZMC of Subdivision H will apply to set the amount and timing of the GEI interest charge deductible to investors who incur the prepayment in carrying on a business, other than investors who are small business taxpayers.
- (g) The anti-avoidance provisions in Part IVA of the 1936 Act will not be applied to deny deductibility of the interest incurred by the investor in respect of borrowings used to fund the purchase of shares under the GEI.

**IMPORTANT:** Paragraphs 18(e) and 18(f) above describe the deductions that are allowable to investors under current law, but investors are advised to carefully examine the information contained in paragraphs 39 to 43 relating to proposed changes to the prepayment rules. Whilst it has been concluded in those paragraphs that the amendments to the law as currently proposed will not affect the GEI, any changes made to the Bill prior to its enactment will need to be carefully monitored. Investors who invest in the GEI after 1pm AEST, 11 November 1999, may be affected by these changes.

## **Assumptions**

19. This Ruling is made on the basis of the following necessary assumptions:

- (a) All of the investors are Australian Residents;
- (b) The investors are not traders in investments and would not be treated for taxation purposes as trading in the GEI;

- (c) All or part of the GEI interest charge may be prepaid by the investors but only in relation to a loan interest payment period of less than 13 months;
- (d) The investors may or will derive assessable income from the GEI but that assessable income will not include income other than dividends and capital gains receipts;
- (e) The dominant purpose of an investor in entering the arrangement is to derive assessable income from their investment in the GEI;
- (f) The arrangement will be executed in the manner described in the "Arrangement" section of this Ruling; and
- (g) All dealings by the investors and the GEI will be at arm's length.

## **Explanations**

### **Section 8-1**

20. The ATO view expressed in media release Nat 99/26 is that part of the 'interest' charged under the GEI is a capital protection fee and is not deductible under section 8-1. The ATO considers that the purpose of this fee is to give the taxpayer capital protection in the event of a share price fall.

21. In the GEI the amount of 'interest' charged is above the normal personal loan rate. This is because the 'interest' charge involves two components: the cost for the use of the Bank's money, and the capital protection fee.

22. The cost (or interest paid) for the use of the Bank's money to acquire income producing assets such as shares is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

23. The capital protection fee ensures that the borrower is protected from liability to repay the principal if the market value of the shares falls below their original purchase price.

24. In effect, the agreement provides that the Bank is required to take the shares as full satisfaction of the debt if the shares have fallen in value below the amount borrowed. The fee compensates the Bank for limiting its right to the repayment of the borrowed money.

25. The ATO view is that the capital protection fee is not deductible because it is incurred for a purpose other than to service or

maintain the borrowed funds. It loses its character as a deductible cost of producing the expected income. The balance of the interest remaining is fully deductible.

26. Investors should only claim deductions equal to the amount of interest determined by the benchmark interest rates (see paragraph 18(b) above).

### **Section 51AAA**

27. Under the GEI it is contemplated that over a period of an investor's involvement there will be assessable income derived by way of dividend income as well as by way of capital gain. Accordingly, the interest would have been deductible under section 8-1 irrespective of whether the capital gain is included in assessable income, or, more precisely, a deduction would have been allowable irrespective of whether the capital gain has been included in assessable income. Accordingly, section 51AAA has no application to an investor in the GEI.

### **Section 82KL**

28. Section 82KL of the 1936 Act will not have any application as this section applies to deny a deduction for a tax benefit in certain situations arising out of a tax avoidance agreement. The GEI is not a tax avoidance arrangement.

### **Subdivision H of Division 3 of Part III of the 1936 Act**

29. This subdivision deals with the period of deductibility of certain advance expenditure. Separate rules apply depending on whether the expenditure is incurred in carrying on a business, whether the taxpayer is a 'small business taxpayer' and whether the prepayment is made during a 4 year transitional period.

### **Subdivision 960-Q - Small business taxpayers**

30. Whether an investor is a 'small business taxpayer' depends upon the individual circumstances of each investor and is beyond the scope of this product ruling. It is the individual responsibility of each investor to determine whether or not they are within the definition of a 'small business taxpayer'.

31. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

32. ‘Average turnover’ is determined under section 960-340 by reference to the average of the taxpayer’s ‘group turnover’. The group turnover is the sum of the ‘value of business supplies’ made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

### **The eligible service period for the purposes of Subdivision H**

33. The GEI interest charge allowable under section 8-1 is in relation to a prepayment of loan interest for a period less than 13 months. Paragraph 82KZL(2)(a) provides that a payment of interest that is made in return for the making available of a loan principal is to be taken, for the purposes of Subdivision H, to be expenditure incurred under an agreement in return for the doing of a thing under the agreement for the period to which the interest payment relates. The eligible service period in relation to a payment of loan interest is determined by reference to the period to which the interest relates which is one year and not to the period of the loan which is three to five years under the GEI.

### **Section 82KZM: prepaid expenditure for small business taxpayers or where the prepaid expenditure is not incurred in carrying on a business**

34. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a ‘small business taxpayer’ or for prepaid expenditure not incurred in carrying on a business that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly to be done within 13 months after the day on which the expenditure is incurred.

35. As the eligible service period in relation to the deductible GEI interest is less than 13 months, section 82KZM will have no application to ‘small business taxpayers’ nor to investors who are not carrying on a business.

### **Sections 82KZMA - 82KZMC - Prepaid expenditure incurred in carrying on a business for taxpayers other than small business taxpayers**

36. For an investor who is not a ‘small business taxpayer’, and the expenditure is incurred in carrying on a business, sections 82KZMA to 82KZMC determine the amount of a deduction otherwise allowable under section 8-1 where expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure

year). These provisions include transitional rules for phasing out the benefit of the immediate deductibility of such prepayments over a four year period.

37. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB sets out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For investors in the GEI, transitional treatment applies to prepayments incurred in the 1999-2000 to 2002-2003 income years.

38. During the transitional period the amount of the deduction available to investors is determined using the formula in sub-section 82KZMB(3), the percentages shown in the table in sub-section 82KZMB(5) and subject to the capping rules of section 82KZMC.

### **Proposed changes to prepayment rules**

39. The proposed legislative amendments under the New Business Tax System (Integrity Measures) Bill 2000 will implement changes announced by the Government to apply from 11 November 1999 which affect all taxpayers that participate in a tax shelter arrangement and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers unless one of the exceptions apply, and no transitional rules will apply.

40. Proposed new sub-section 82KZME(3) sets out the requirements for agreements subject to the new law:

- (a) the taxpayer's allowable deductions for the expenditure year that are attributable to the agreement must exceed the taxpayer's assessable income (if any) for the expenditure year that is attributable to the agreement; and
- (b) the taxpayer does not have day to day control over the operation of the agreement (whether or not the taxpayer has the right to be consulted or give directions); and
- (c) at least one of these must be satisfied:
  - (i) there is more than one participant in the agreement in the same capacity as the taxpayer;
  - (ii) the person who manages, arranges or promotes the agreement, or an associate of that person, manages, arranges or promotes similar agreements for other taxpayers.

41. The ATO considers the arrangement relating to the GEI and described at paragraph 14 of this product ruling is within the description of the proposed provisions, in respect of any year in which the allowable deductions incurred in respect of the GEI exceed the assessable income derived from it. In particular, in respect of paragraph (b) of the proposed sub-section above, investors in the GEI do not have day to day control over the operation of the product, other than to give directions as to the shares to be bought or sold.

42. The types of agreements that are to be caught by the proposed provisions are broadened beyond simply the contract under which expenditure might be incurred to include the entire arrangement that such a contract may form part of. Under proposed sub-section 82KZME(4), the relevant 'agreement' is all the contractual arrangements and activities associated with the participation in the GEI, including the financing, share purchase, share holding and disposal arrangements.

43. However, the GEI deductible annual fixed interest amount also satisfies Exception 1 to the proposed amendments, relating to certain negatively geared investments. The exception criteria is set out under proposed sub-section 82KZME(5). Consequently the proposed changes to the prepayment rules will not have application to the prepaid interest under the GEI for the following reasons:

- (i) The prepaid interest expenditure under the GEI is on money borrowed to acquire shares that are listed for quotation on the official list of the Australian Stock Exchange
- (ii) The investor can reasonably be expected to obtain dividends from the investment
- (iii) The investor will not obtain any other kind of assessable income from the investment, except for capital gains
- (iv) All aspects of the GEI are at arm's length.

#### **Part IVA**

44. Provided that the arrangement is entered into and carried out as disclosed (see the **Arrangement** part of this ruling), it is accepted that the arrangement is a normal commercial transaction and Part IVA will not apply.

#### **Detailed contents list**

45. Below is a detailed contents list for this Product Ruling:

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**Commissioner of Taxation**  
30 May 2001

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*Previous draft:*  
Not previously issued in draft form

TR 92/1; TR 92/20; TR 95/33,  
TR 97/16; TD 93/34; PR 1999/95;  
PR 2000/6

*Related Rulings/Determinations:*

*Subject references:*

- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- small business taxpayer
- taxation administration
- tax avoidance
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 Pt IVA
- ITAA 1997 8-1
- ITAA 1997 960-335
- ITAA 1997 960-340
- ITAA 1997 960-345
- ITAA 1997 960-350

*Legislative references:*

- ITAA 1936 51AAA
- ITAA 1936 82KL

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