



# ***PR 2002/111 - Income tax: tax consequences of investing in UBS Highly Geared 'ISO' Series Instalment Warrants - cash applicants and secondary market purchasers***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *17 December 2003*



## Product Ruling

# Income tax: tax consequences of investing in UBS Highly Geared 'ISO' Series Instalment Warrants - cash applicants and secondary market purchasers

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### *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**, **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.*

*[Note: This is a consolidated version of this document. Refer to the Tax Office Legal Database (<http://law.ato.gov.au>) to check its currency and to view the details of all changes.]*

## **No guarantee of commercial success**

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product. 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 participants 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 this product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential participants 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

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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

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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 acquisition of a UBS Highly Geared 'ISO' Series Instalment Warrant ('UBS Instalment(s)') which provides an investment in shares that are listed for quotation on the Australian Stock Exchange ('ASX'), and a put option using a loan made by UBS AG, Australia Branch ('UBS').

### Tax law(s)

2. The tax laws dealt with in this Ruling are:
- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - section 8-1 (ITAA 1997);
  - section 20-20 (ITAA 1997);
  - section 25-25 (ITAA 1997);
  - section 104-10 (ITAA 1997);
  - subsection 104-10(7) (ITAA 1997);
  - section 104-25 (ITAA 1997)
  - section 109-5 (ITAA 1997);
  - section 110-25 (ITAA 1997);
  - subsection 110-45(3) (ITAA 1997);
  - section 112-35 (ITAA 1997);
  - section 115-5 (ITAA 1997)
  - section 116-20 (ITAA 1997);
  - section 116-55 (ITAA 1997);
  - section 134-1 (ITAA 1997);
  - section 960-335 (ITAA 1997);
  - section 960-340 (ITAA 1997);

- section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KL (ITAA 1936);
- section 82KZM (ITAA 1936);
- section 82KZMA (ITAA 1936);
- section 82KZMB (ITAA 1936);
- section 82KZMC (ITAA 1936);
- section 82KZMD (ITAA 1936);
- section 82KZME (ITAA 1936);
- section 82KZMF (ITAA 1936);
- section 97 (ITAA 1936); and
- Part IVA (ITAA 1936).

### **Class of persons**

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below, through Cash Applications or secondary market purchases, on or after the date this Ruling is made. They will have, at the time of entering into the arrangement, a purpose of staying in the arrangement until it is completed and 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'.

4. This Ruling does not apply to investors who acquire UBS Instalments through a Shareholder Application or an Instalment Holder Application.

### **Qualifications**

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

6. 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. The Ruling will be withdrawn or modified.

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## Date of effect

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8. This Ruling applies prospectively from 4 September 2002, the date this Ruling is made. 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).

9. 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).

## Withdrawal

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10. This Product Ruling is withdrawn and ceases to have effect after 30 June 2006. 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

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

- (a) Application for Product Ruling dated 30 January 2002, as amended by letters dated 6 August 2002 and

20 August 2002 received from Blake Dawson Waldron on behalf of UBS;

- (b) Offering circular dated 20 August 2002 for the UBS Instalments (the 'Offering Circular') prepared and issued by UBS;
- (c) UBS Instalment Deed dated 20 August 2002 (the 'Instalment Deed') to be executed by UBS (as Issuer) and UBS Nominees Pty Ltd (as Security Trustee);
- (d) UBS Instalment Nominee Deed dated 20 August 2002 (the 'Nominee Deed') to be executed by UBS Nominees Pty Ltd ('Nominees'); and
- (e) UBS Instalment Loan Agreement dated 20 August 2002 (the 'Loan Agreement').

12. On acceptance of an Investor's application for a UBS Instalment, the Investor will enter into the Loan Agreement with UBS, appoint Nominees to act as its nominee on the terms of the Nominee Deed and will accept the UBS Instalments on the terms and conditions set out in the Instalment Deed. Investors can also purchase UBS Instalments once they are listed on the ASX.

13. UBS Instalments are a highly geared product that allows Investors to gain exposure to share price movements and dividends without paying the full price of the share upfront. The gearing is the result of a loan provided by UBS to Investors to fully or partly fund the investment in shares. The Loan amount provided by UBS is fixed for each Interest Period and for the first Interest Period is as specified in the Offering Circular. The gearing levels for UBS Instalments are as specified in the Offering Circular and will be in excess of 70% but not more than 100% based on the market price of the Underlying Parcel (see paragraph 14(b) below) as at the date the Loan amount is fixed for the purposes of applying for ASX approval for admission to trading status.

14. The details of the arrangement the subject of this Ruling are summarised as follows:

- (a) the UBS Instalment involves the Investor acquiring shares in an ASX listed company (via Nominees), acquiring a put option ('Put Option') (see below) and taking a limited recourse loan for up to five years (the 'Loan') from UBS;
- (b) the Investor can choose to invest in one or more of the shares listed in the Offering Circular. Each share comprises one 'Underlying Parcel' for a UBS Instalment. The amount of the Loan provided to fund the purchase of each Underlying Parcel will be fixed by

the Issuer on inception based on the then market value of the share, and in relation to UBS Instalments which have a loan reset facility, the Loan amount will be reset at the end of each interest period (on each Reset Date) based on the then market value of the shares;

- (c) repayment of the Loan will be secured by a mortgage over the Underlying Parcel which will be held by the Security Trustee on trust for the Investor (the 'Mortgaged Property'). Each trust and each Underlying Parcel to which it relates will be kept as a separate trust and there will be no pooling of interests or property to which the trust relates;
- (d) the Loan is provided on a limited recourse basis such that UBS's right to repayment of principal is limited to the amount which it can obtain by enforcing its rights in respect of the Mortgaged Property. UBS is entitled to exercise its security interest in respect of some or all of the Mortgaged Property in case of any event of default by the Investor, such as a failure to pay interest and borrow fees (if any) due on Application or on each Reset Date;
- (e) the UBS Instalment is open to initial investment by three types of Investors: Cash Applicants, Shareholder Applicants, and Instalment Holder Applicants. They will also be listed on the ASX so that Investors may participate by purchasing UBS Instalments on the secondary market. This Ruling is applicable only to Cash Applicants and secondary market purchasers;
- (f) a Cash Applicant is a person who has acquired the UBS Instalment by submitting a Cash Application Form and making the first payment in cash. Where the then share price is greater than the Loan amount, the entire Loan amount and part of the first payment will be applied towards the acquisition of the shares comprising the Underlying Parcel. Another part of the first payment will be used to prepay interest for the current interest period and the balance, if any, will relate to any borrow fees (see paragraph 14(i) below) and taxes. Where the Loan amount is greater than the then share price, part of the Loan amount will be applied towards the purchase of the shares comprising the Underlying Parcel and the remainder of the Loan, together with the first payment contributed by the Cash Applicant, will be used to prepay interest for the current interest period and to pay for any borrow fees and taxes. UBS will confirm the

- allocation of the first payment by issuing a confirmation to successful applicants;
- (g) interest on the Loan is payable in advance for each interest period (the 'Interest Amount'). Interest is therefore payable at the commencement of the Loan and on each Reset Date. On transfer of a UBS Instalment on the secondary market, the seller will receive a pro rata refund of previously prepaid interest from UBS. Furthermore, where UBS brings forward the Final Maturity Date or fixes an Additional Reset Date, UBS will refund a pro-rata portion of the interest prepaid to the Investor (less any costs incurred by UBS for the early termination of its funding and hedging arrangements). In all other circumstances, interest prepaid is non-refundable;
  - (h) the interest rate charged on the Loan will be fixed for each interest period. However, where the UBS Instalment has a loan reset facility, the interest rate may vary between interest periods as it will be reset on each Reset Date to reflect changes in market interest rates. The interest rate charged will reflect UBS's cost of funds in providing the Loan plus its profit margin;
  - (i) a borrow fee ('Borrow Fee') will also be payable on application by Cash Applicants and on each Reset Date by Holders of UBS Instalments whose Loan is reset. In respect of these Investors, the Borrow Fee will comprise one or both of two components, a fee for the grant of the Put Option and an amount which is paid for acquiring the Loan from UBS or for resetting the Loan amount by UBS. Borrow Fees are not payable for secondary market sales and purchases, although part of the price paid by a secondary market purchaser will be attributed to the purchase of the seller's Put Option;
  - (j) where UBS grants to the Investor a Put Option over the Underlying Parcel on acceptance of an application or on a Reset Date, all or part of the Borrow Fee charged will be allocated to the Put Option purchase price payable by the Investor in consideration for the grant (the breakdown of the Borrow Fee between the Put Option Purchase Price and payment for acquiring the Loan from UBS or for resetting the Loan amount by UBS will be notified to Investors in a confirmation issued by UBS). The Put Option, exercisable at any time before the closing time on the earlier of the next Reset Date or the Final Maturity Date, allows the

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- Holder to sell the Underlying Parcel to UBS for a price equal to the outstanding Loan amount at that date;
- (k) the Loan provided by UBS is a 'limited recourse' loan for up to five years. Under the terms of the Loan Agreement, UBS's ability to recover the principal amount of the Loan will be limited to either:
- (i) if the Put Option is exercised by the Holder – the amount payable to the Investor under the Put Option; or
  - (ii) if the Put Option is not exercised by the Holder - the amount recoverable by UBS on the enforcement of its rights in respect of the Mortgaged Property;
- (l) in all other respects (for example, payment of interest, borrow fees and taxes), UBS's recourse against an Investor will not be limited;
- (m) during the period of the Loan, Investors will be entitled to all dividends and distributions paid on the shares comprising the Underlying Parcel (the 'Shares'). The Investor may also direct the Security Trustee to attend and vote at shareholders' meetings of the Company in which the Shares are held;
- (n) once listed on the ASX, UBS Instalments may be traded on the secondary market. A seller on the ASX will dispose of its interest in the Shares comprising the Underlying Parcel and any Put Option to the purchaser. The purchaser will drawdown a new Loan from UBS on the trade date and will prepay interest for the period beginning on the trade date up until the next Reset Date or maturity date (as applicable). The amount borrowed from UBS will be paid by the purchaser to the seller, who will use this amount to repay their outstanding Loan balance, and UBS will use the interest paid by the purchaser to refund to the seller a pro rata portion of interest previously prepaid;
- (o) for UBS Instalments that have a loan reset facility, Reset Dates occur annually up until the Final Maturity Date. On each Reset Date, UBS can elect to terminate the arrangement or reset the Loan amount. Where the reset option is chosen, UBS will set a new Loan amount for the new interest period which will be based on the market price of the Shares comprising the Underlying Parcel around the time of the Reset Date, and will also specify a new Interest Rate and Borrow Fees applicable

to the new interest period. The new Loan amount may be more or less than the Loan amount for the immediately preceding interest period. UBS may also, in certain specified circumstances, fix an Additional Reset Date. In such circumstances, UBS may reset the Holder's Loan Amount, Interest Rate and the amount of any Borrow Fees;

- (p) where the Loan is reset, the Investor will have a number of options:
- (i) exercise the UBS Instalment, pay the outstanding Loan amount (the 'Completion Payment') to UBS and have the shares comprising the Underlying Parcel transferred to it;
  - (ii) maintain its holding of UBS Instalments by electing the Cash Rollover Option. If this election is made and the Loan amount increases as a result of this reset, the additional Loan proceeds, after deducting interest cost, Borrow Fees (if applicable) and taxes (collectively referred to as the 'reset costs'), will be paid to the Investor. If the Loan amount is reduced as a result of the reset, or the amount of the increase is not sufficient to cover the reset costs, the Investor will be required to pay to UBS the amount of the shortfall. The Loan will then continue until the next Reset Date;
  - (iii) do nothing and be deemed to have elected the Non-Cash Rollover Option. If the Loan amount is increased on reset, the additional Loan proceeds will, after application against reset costs, be applied to purchase for the Investor further UBS Instalments in the same series on the secondary market. If the Loan amount is reduced on reset or does not increase enough to cover the reset costs, the Loan will be repayable on a number of UBS Instalments and UBS will enforce its security interest in respect of the Underlying Parcels relating to those UBS Instalments. UBS will sell those shares and apply the proceeds against the costs of the sale, the reset costs and in repayment of the Loans for the terminated Instalments;
  - (iv) sell the UBS Instalments on the secondary market;

- (v) where the market value of the Underlying Parcel at the closing time on the Reset Date is less than or equal to the Investor's outstanding Loan amount, exercise the Put Option and transfer its interest in the Underlying Parcel to UBS for an amount equal to the outstanding Loan amount. UBS will apply the amount payable to the Investor in respect of such transfer in satisfaction of the Investor's obligation to repay the Loan; or
- (vi) if UBS offers a new series of UBS Instalments over the shares comprising the Underlying Parcel, roll over their investment from the expiring or resetting series to the new series as an Instalment Holder Applicant;
- (q) at the final maturity date, or at any time prior to that date, Investors may exercise their UBS Instalments by giving to UBS a completion notice and paying to UBS the Completion Payment. The shares comprising the Underlying Parcel will then be transferred to the Investor free of any security interest. Alternatively, where the market value of the Underlying Parcel at maturity is less than the outstanding Loan amount, the Investor may exercise the Put Option and transfer its interest in the Underlying Parcel to UBS for the outstanding Loan amount. UBS will apply the amount payable to the Investor in respect of such transfer in satisfaction of the Investor's obligation to repay the Loan;
- (r) if, at the final maturity date, no completion notice is given by the Investor and the Put Option is not exercised, UBS will enforce its security interest and exercise its power of sale. The proceeds of sale will be applied towards repayment of the outstanding balance of the Loan and any costs incurred by UBS or the Security Trustee in relation to the sale. Any remaining proceeds will be paid to the Investor. Due to the limited recourse nature of the Loan, if the sale proceeds are insufficient to repay the Loan in full, the Investor will not be required to pay the shortfall; and
- (s) UBS may, in certain specified circumstances, fix an Early Final Maturity Date. In such circumstances, the Final Maturity Date will be brought forward and the Holder's UBS Instalment will terminate on the Early Final Maturity Date.

**The Participants**

15. UBS is the Issuer of the UBS Instalment and also the provider of the Loans to Investors to fund the acquisition of the Underlying Parcel.

16. UBS Nominees Pty Ltd holds the legal title to the Underlying Parcel as nominee for each Investor.

17. The Investors may be individuals, companies, trusts or superannuation funds.

**Ruling**

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

- (a) the Interest Amount paid by an Investor under the Loan Agreement is deductible to the Investor under section 8-1 of the ITAA 1997;
- (b) the Interest Amount paid by a secondary market purchaser of the UBS Instalment in respect of the period from the contract date for transfer of the UBS Instalment (the Loan drawdown date) until the next Reset Date or Final Maturity Date (as applicable) is deductible to the Investor under section 8-1 of the ITAA 1997;
- (c) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction for the Interest Amount allowable under section 8-1 of the ITAA 1997;
- (d) section 82KL of the ITAA 1936 will not apply to deny deductibility of the Interest Amount allowable under section 8-1 of the ITAA 1997;
- (e) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for an Interest Amount incurred under the UBS Instalment;
- (f) section 82KZM of the ITAA 1936 will not apply to deny immediate deductibility for an Interest Amount incurred by the Investor under the UBS Instalment where at least one of the following applies for the year of income;
  - the Investor is a Simplified Tax System ('STS') taxpayer; or

- the Investor is an individual who does not incur the expenditure in carrying on a business;
- (g) sections 82KZMA, 82KZMB, 82KZMC and 82KZMD of the ITAA 1936 will apply to determine the amount and timing of deductions for the Interest Amount incurred under the UBS Instalment that is deductible to an Investor (other than an STS taxpayer for that year of income) who is a taxpayer that is not an individual and does not carry on a business;
- (h) if the Investor's Put Option is not exercised, that portion of any Borrow Fee charged on application and on each Reset Date that is attributable to the purchase of the Put Option will be included in the Investor's cost base of the Put Option under section 110-25 of the ITAA 1997;
- (i) if the Investor's Put Option is exercised, that part of the Borrow Fee attributable to the purchase of the Put Option will be included under section 134-1 of the ITAA 1997 in the Investor's cost base of the Shares comprising the Underlying Parcel acquired;
- (j) the remaining portion of any Borrow Fee charged on application and on each Reset Date represents a payment for acquiring the Loan from UBS or for resetting the Loan amount by UBS. This portion of the Borrow Fee will be deductible to the Investors under section 25-25 of the ITAA 1997;
- (k) for secondary market purchasers the cost base of the Put Option will be:
- if the market value of the share at the time of purchase is greater than the purchaser's Loan amount, the cost base of the Put Option, determined under sections 110-25 and 112-35 of the ITAA 1997, is the price of the UBS Instalment plus the purchaser's Loan amount less the sum of the market value of the share and the Interest Amount prepaid by the purchaser on the Loan amount; and
  - if the market value of the share at the time of purchase is less than the purchaser's Loan amount, the cost base of the Put Option, determined under sections 110-25 and 112-35 of the ITAA 1997, is the price of the UBS Instalment plus the purchaser's Loan amount less the sum of the purchaser's Loan amount

and the Interest Amount prepaid by the purchaser on the Loan amount;

- (l) a CGT event will occur under section 104-25 of the ITAA 1997 on a Reset Date or Final Maturity Date if the Put Option is not exercised and lapses. The capital proceeds received on lapsing of the Put Option will be nil;
- (m) the date of acquisition of the beneficial interest in the Underlying Parcel and any Put Option is, in the case of a Cash Applicant, the date of acceptance of the application, or in the case of a secondary market purchaser of UBS Instalments, the contract date for transfer of the UBS Instalment;
- (n) no CGT event arises when the legal title to the Underlying Parcel is transferred by the Security Trustee to the Investor on completion of the UBS Instalment;
- (o) a CGT event will occur under section 104-10 of the ITAA 1997 on transfer of the interest in the Underlying Parcel and the Put Option to a secondary market purchaser on sale of the UBS Instalment on the secondary market. The capital proceeds received by the seller in respect of the disposal of the Put Option will be equal to the cost base attributed to the secondary market purchaser for the Put Option as determined under paragraph 18(k) above. The remainder of the total capital proceeds received represents the capital proceeds for the disposal of the interest in the Underlying Parcel;
- (p) a CGT event will arise under section 104-10 of the ITAA 1997 to the Investor where the Completion Payment is not made and the Underlying Parcel is sold by UBS exercising its power of sale under the Security Interest. The cost base in the Underlying Parcel will be reduced by the excess (if any) of the Loan amount over the market value of the Underlying Parcel in accordance with the provisions of subsection 110-45(3) of the ITAA 1997;
- (q) the total capital proceeds received by a seller in the secondary market will include the amount applied to discharge the seller's Loan, less the interest refund amount received by the seller under paragraph 14(n) above. This amount of total capital proceeds should be apportioned between the Put Option (in the manner described in paragraph 18(o) above) and the seller's interest in the Underlying Parcel, both of which are

disposed of as a result of the sale of the UBS Instalment on the ASX;

- (r) any capital gain realised by an Investor on sale of the UBS Instalment or on sale of an Underlying Parcel received pursuant to completion of a UBS Instalment, will be treated as a discount capital gain pursuant to section 115-5 of the ITAA 1997 where the Investor is an individual, a complying superannuation entity, or a trust and has held the UBS Instalment for at least 12 months;
- (s) any refund of prepaid interest received by the seller in the secondary market will be assessable income to the seller under section 6-5 or section 20-20 of the ITAA 1997 to the extent that the seller has been entitled to a deduction for payments of an Interest Amount under paragraphs 18(a) or 18(b) above;
- (t) only the Investors in UBS Instalments (and not the Security Trustee) are assessable on all of the income derived from the Underlying Parcel while the Underlying Parcel is the subject of the separate Trust; and
- (u) the anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not apply to an Investor in respect of the UBS Instalment.

## Assumptions

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19. This Ruling is made on the basis of the following assumptions:
- (a) all of the Investors are Australian Residents;
  - (b) the Investors are not traders in investments and are not treated for taxation purposes as either trading in the Underlying Parcel or carrying on a business of investing in the Underlying Parcel. In particular, the Underlying Parcel is not trading stock or a revenue asset to the Investor;
  - (c) the interest for each interest payment period may be prepaid by the Investors but only in relation to interest payment periods of 12 months or less that ends on or before the last day of the income year following the expenditure year;

- (d) the dominant purpose of an Investor in entering the arrangement is to derive assessable income from their investment in the UBS Instalments;
- (e) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;
- (f) all dealings by the Investors and UBS will be at arm's length; and
- (g) the Underlying Parcel will not be the subject of any securities lending arrangement entered into by or on behalf of the Investor.

## **Explanations**

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### *Section 8-1 of the ITAA 1997*

20. The cost (or interest paid) of a borrowing used 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).

21. The ATO view is that no part of the interest charged by UBS under the Loan Agreement is a capital protection fee.

22. Where UBS has granted to the Investor a Put Option, the capital protection provided under the arrangement is provided by the Put Option. The Interest Amounts incurred by an Investor in relation to monies borrowed from UBS under the Loan Agreement will therefore be an allowable deduction pursuant to section 8-1 to the extent that the interest is incurred by the Investor in gaining or producing assessable income. This is the case regardless of whether the Investor acquired the UBS Instalment by application or by purchase on the ASX.

### *Borrow Fee*

23. Part of the Borrow Fee is a payment for the purchase of the Put Option and the balance represents a payment for acquiring the Loan from UBS or for resetting the Loan amount by UBS. This payment is deductible under section 25-25 of the ITAA 1997.

24. In the arrangement, where UBS has granted to the Investor a Put Option, all or part of the Borrow Fee paid by the Cash Applicant or the Holder on a Reset Date is allocated to the consideration for that Put Option (being the 'Put Option Purchase Price'). Payment of the Put Option Purchase Price ensures that the Investor is protected from

personal liability to repay the principal of the Loan if the market value of the Underlying Parcel falls below the outstanding Loan amount. In effect, the Put Option ensures that UBS will acquire the Underlying Parcel in full satisfaction of the Loan if the Underlying Parcel has fallen in value below the amount borrowed.

25. The ATO view is that the Put Option Purchase Price is a capital protection fee and is not deductible as it is incurred for a purpose other than to service or maintain the borrowed funds. The fee is capital in nature, being paid to acquire an asset, namely, the Put Option.

26. The ATO is of the view that that part of the Borrow Fee which is attributable to the Put Option Purchase Price forms the cost base of the Investor's Put Option if that option is not exercised and forms part of the cost base of the Underlying Parcel if the option is exercised. If the Put Option is not exercised, it will lapse on the next Reset Date or Final Maturity Date, whichever is applicable.

### **Section 51AAA of the ITAA 1936**

27. Section 51AAA denies a deduction otherwise allowable under section 8-1 of the ITAA 1997 in circumstances where the deduction would not have been available if a net capital gain made by the Investor were not included in the Investor's assessable income.

28. An Investor is expected to derive assessable income over the period of their investment in the UBS Instalment from both dividend income and capital gains obtained on any sale of the UBS Instalment. As assessable income will be derived, and a deduction allowed, irrespective of whether any net capital gain is included in the Investor's assessable income, section 51AAA will not operate to deny a deduction to an Investor for Interest Amounts under section 8-1.

### **Section 82KL of the ITAA 1936**

29. The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Insufficient additional benefits will be provided to trigger the application of section 82KL. It will not apply to deny the deductions otherwise allowable under section 8-1 of the ITAA 1997.

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

30. This Subdivision deals with the timing of deductions for certain advance expenditure incurred under an agreement in return for the doing of a thing under that agreement that will not be wholly done within the same year of income. Separate rules apply depending on

whether the expenditure is incurred in carrying on a business, whether the Investor is an 'STS taxpayer', whether the Investor is an individual and whether the expenditure qualifies for transitional treatment. This Subdivision does not apply to 'excluded expenditure' which is defined in subsection 82KZL(1) to include amounts of less than \$1,000.

*Subdivision 328-F and Subdivision 328-G of the ITAA 1997 – STS taxpayer*

31. An Investor will be an STS taxpayer for an income year if the Investor is eligible to be an STS taxpayer for that year and the Investor notifies the Commissioner of the choice to become such a taxpayer for that year.

32. An Investor will be eligible to be an STS taxpayer for an income year if the Investor carries on a business and the STS average turnover of the business and related business for that year is less than \$1 million and the business and related businesses have depreciating assets with a total adjustable value below \$3 million at the end of that year.

*The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936*

33. The interest allowable under section 8-1 of the ITAA 1997 is in relation to a prepayment of loan interest for a period that is not more than 12 months. Paragraph 82KZL(2)(a) of the ITAA 1936 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 12 months, and not to the period of the loan, which is up to 5 years for UBS Instalments.

*Sections 82KZME and 82KZMF of the ITAA 1936: prepaid expenditure and 'tax shelter' arrangements*

34. The rules in sections 82KZME and 82KZMF apply, subject to the exceptions in section 82KZME, where expenditure is incurred in relation to a 'tax shelter' arrangement for the doing of a thing that is not to be wholly done within the expenditure year.

35. For the purposes of section 82KZME, 'agreements' are broadly defined to include an entire arrangement of which a contract may form part. Under subsection 82KZME(4), the relevant

'agreement' is all the contractual arrangements and activities associated with the participation in the UBS Instalments, including the financing, share purchase, shareholding and disposal arrangements.

36. Under the arrangement, when the purchaser acquires UBS Instalments, they acquire beneficial ownership of the Underlying Parcel of shares.

37. Exception 1, as contained in subsection 82KZME(5), applies to exclude the interest incurred on borrowings under the UBS Instalments from the operation of section 82KZMF, as:

- the prepaid interest expenditure under the UBS Instalments is incurred in respect of money borrowed to acquire shares that are listed for quotation on the ASX;
- the Investor can reasonably be expected to obtain dividends from the investment;
- the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- all aspects of the UBS Instalments are at arm's length.

Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 38 to 44 below.

*Section 82KZM of the ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure*

38. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a taxpayer that is either:

- an STS taxpayer for the year of income; or
- a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

39. The expenditure must not be excluded expenditure and must be incurred otherwise than in carrying on a business. Section 82KZM applies if the eligible service period for the expenditure is longer than 12 months, or the eligible service period for the expenditure is 12 months or shorter but ends after the last day of the year of income after the one in which the expenditure was incurred and the expenditure would otherwise be immediately deductible under section 8-1 of the ITAA 1997.

40. As the eligible service period in relation to the deductible interest for UBS Instalments is not more than 12 months and does not end after the last day of the year of income after the one in which the expenditure was incurred, section 82KZM will have no application to

Investors who are STS taxpayers for the year of income, or to Investors who are individuals and the expenditure is not incurred in carrying on a business. Investors who satisfy these tests will be able to claim an immediate deduction for the interest incurred.

*Sections 82KZMA - 82KZMD of the ITAA 1936: prepaid non-business expenditure incurred by non-individual and non-STs taxpayers*

41. Sections 82KZMA, 82KZMB, 82KZMC and (in respect of income years after the year of income including 21 September 2002) section 82KZMD set the amount and timing of deductions for expenditure for an Investor (other than an STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not incur the expenditure in carrying on a business.

42. The expenditure must not be excluded expenditure and must be incurred in return for the doing of a thing under an agreement that is not to be wholly done within the expenditure year.

43. For these taxpayers, the deduction for prepaid interest on the UBS Instalment will be apportioned over the relevant interest payment period, subject to the transitional provisions in section 82KZMB (applying to expenditure incurred before or during the Investor's year of income that includes 21 September 2002).

44. Section 82KZMD will not apply to an Investor in respect of interest payments on the borrowings under the UBS Instalments incurred before or during the Investor's year of income that includes 21 September 2002 as the eligible service period to which the interest payments relate will end not more than 13 months after the expenditure is incurred.

**Sections 110-25, 112-35 and 134-1 of the ITAA 1997**

***Cost base of Put Option – Cash Applicant and Holder on Reset Date***

45. If the Put Option is not exercised, that portion of the Borrow Fee paid by a Cash Applicant or a Holder on a Reset Date that is attributable to the purchase of the Put Option will be included in the Investor's cost base of the Put Option under section 110-25.

46. If the Put Option is exercised, that portion of the Borrow Fee that is attributable to the purchase of the Put Option will be included in the Cash Applicant's or Holder's cost base of the shares comprising the Underlying Parcel under section 134-1.

***Cost base of Put Option – secondary market purchaser***

47. If the market value of the share at the time of purchase is greater than the purchaser's Loan amount, the cost base of the Put Option, determined under sections 110-25 and 112-35, is the price of the UBS Instalment plus the purchaser's Loan amount less the sum of the market value of the share and the interest prepaid by the purchaser on the Loan amount.

48. If the market value of the share at the time of purchase is less than the purchaser's Loan amount, the cost base of the Put Option, determined under sections 110-25 and 112-35, is the price of the UBS Instalment plus the purchaser's Loan amount less the sum of the purchaser's Loan amount and the interest prepaid by the purchaser on the Loan amount.

**Sections 104-10, 104-25 and 116-20 of the ITAA 1997*****CGT Events A1 and C2 in respect of Put Option***

49. If the Put Option is transferred as a result of a secondary market sale and purchase of a UBS Instalment, a CGT Event A1 will occur for the seller. The capital proceeds received for the sale of the Put Option will be the Put Option Purchase Price paid by the secondary market purchaser of the UBS Instalment.

50. If the Put Option lapses on a Reset Date or Final Maturity Date a CGT event C2 will occur for the Investor. The capital proceeds received in respect of this event will be nil.

**Section 109-5 of the ITAA 1997*****Acquisition of a CGT asset***

51. Section 109-5 applies to Investors to treat them as having acquired the Underlying Parcel and the Put Option at the time from which the Investors obtain beneficial ownership of the Underlying Parcel. This time is, for a Cash Applicant, the time the application was accepted, and for a secondary market purchaser, the contract date for the transfer of the UBS Instalment.

**Subsection 104-10(7) of the ITAA 1997*****Time of disposal***

52. When the Completion Payment is made, no CGT event will arise in respect of the transfer of the legal title to the Underlying Parcel from the Security Trustee to the Investor by virtue of subsection 104-10(7).

**Section 104-10 of the ITAA 1997*****CGT Event A1***

53. A CGT event will arise to the Investor if the Investor does not make the Completion Payment and the Underlying Parcel is sold to UBS or to a third party. The cost base in the Underlying Parcel will be reduced by the excess (if any) of the Loan amount over the market value of the Underlying Parcel in accordance with the provisions of subsection 110-45(3) of the ITAA 1997.

**Sections 116-20 and 116-55 of the ITAA 1997**

54. On the sale of a UBS Instalment on the ASX, the seller's capital proceeds under section 116-20 will include the amount applied to discharge the Loan. The seller's total capital proceeds received will therefore be the sum of the price received from the on-market sale of the UBS Instalment and the Loan amount, less any refund of prepaid interest received by the seller.

**Section 115-5 of the ITAA 1997*****Discount Capital Gains***

55. Division 115 allows a taxpayer a discount on capital gains in certain circumstances. In accordance with section 115-5, any capital gain realised by an Investor on the sale of the UBS Instalment or on the sale of an Underlying Parcel received pursuant to the completion of a UBS Instalment will be treated as a discount capital gain where the Investor is an individual, a complying superannuation entity, or a trust and has held the UBS Instalment for at least 12 months.

***Section 6-5 and/or section 20-20 of the ITAA 1997***

56. Any refund of prepaid interest received by a seller in the secondary market will be included in the assessable income of the seller pursuant to section 6-5 as it will be income according to ordinary concepts or alternatively will be an assessable recoupment under section 20-20.

**Section 97 of the ITAA 1936**

57. The Investors are presently entitled to all of the income derived from the Underlying Parcel. Therefore, section 97 will apply to assess the Investors on the income derived from the Underlying Parcel. The Security Trustee will not be subject to tax on this income.

**Part IVA of the ITAA 1936**

58. Provided that the arrangement is entered into and carries 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**

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**Commissioner of Taxation**

4 September 2002

*Previous draft:*

Not previously issued in draft form

*Related Rulings/Determinations:*TR 92/1; TR 92/20; TR 95/33,  
TR 97/16; TD 93/34; PR 1999/95*Subject references:*

- financial products

- interest expenses

- prepaid expenses

- product rulings

- public rulings

- small business taxpayer

- taxation administration

- tax avoidance

*Legislative references:*

- TAA 1953 Part IVAAA

# PR 2002/90

- ITAA 1936 51AAA
  - ITAA 1936 82KL
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  - ITAA 1936 82KZMC
  - ITAA 1936 82KZMD
  - ITAA 1936 82KZME
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  - ITAA 1936 82KZME(5)
  - ITAA 1936 82KZMF
  - ITAA 1936 Subdiv H, Div 3, Pt III
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