

# ***PR 2002/79 - Income tax: deductibility of interest incurred on borrowings under the UBS Warburg Protected Equity Product***

 This cover sheet is provided for information only. It does not form part of *PR 2002/79 - Income tax: deductibility of interest incurred on borrowings under the UBS Warburg Protected Equity Product*

 This document has changed over time. This is a consolidated version of the ruling which was published on *5 June 2002*



# Product Ruling

## Income tax: deductibility of interest incurred on borrowings under the UBS Warburg Protected Equity Product

Contents	Para
What this Product Ruling is about	1
Date of effect	7
Withdrawal	9
Arrangement	10
Ruling	14
Assumptions	15
Explanations	16
Detailed contents list	41

### 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.

### 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 in future years to confirm the arrangement has been implemented as described below and to ensure that 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.

Potential participants 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.

## **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 grant of a Put Option and the borrowing of moneys from UBS Warburg Australia Ltd ('UBS Warburg') to fund the acquisition of shares listed on the Australian Stock Exchange and or units of a widely held unit trust on the terms of a lending and investment facility named the 'UBS Warburg Protected Equity Product' which is referred to in this Ruling as the 'PEP'.
2. This Ruling does not address the tax implications of granting a call option under the limited trading facility of the PEP.

### **Tax law(s)**

3. The tax laws dealt with in this Ruling are:
  - section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - section 110-25(2) (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); and
  - Part IVA (ITAA 1936).

### **Class of persons**

4. 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 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'.

### **Qualifications**

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

6. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright, apart from any use as permitted under the *Copyright Act 1968*, no Product Ruling may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

### **Date of effect**

---

7. This Ruling applies prospectively from 5 June 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).

8. 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**

---

9. This Product Ruling is withdrawn and ceases to have effect after 30 June 2005. 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**

---

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

- Application for a Product Ruling dated 15 March 2002 received from Blake Dawson Waldron on behalf of UBS Warburg, amended by the fax transmission dated 20 May 2002 and letter dated 22 May 2002;
- Information Memorandum for the Protected Equity Product (the 'Information Memorandum'), prepared and issued by UBS Warburg, draft dated 21 May 2002;
- UBS Warburg Protected Equity Product Loan and Put Option Agreement (the 'Loan Agreement'), draft dated 21 May 2002;
- Example Protected Equity Product Term Sheet prepared and issued by UBS Warburg (the 'Example Term Sheet'), draft dated 21 May 2002; and
- Sample Confirmation Notice (the 'Confirmation'), prepared and sent to Investors by UBS Warburg, draft dated 21 May 2002.

Each Investor will enter into the Loan Agreement with UBS Warburg on or after the date of this Ruling.

11. The details and aspects of the arrangement subject to this Ruling are summarised as follows.

- (a) The PEP involves the grant of a Put Option and the making of a loan by UBS Warburg to an Investor for a fixed term of either one, two, three, four or five years (at the Investor's option). The term will commence on the issue date agreed between the Investor and UBS Warburg. Although the issue date (and therefore the maturity date) will not necessarily be the same for all Investors in the PEP, each Investor's investment will have a term of either one, two, three, four or five years;
- (b) The funds provided under the loan are used to finance 100% of the purchase price of one or more 'Approved Securities' to be acquired by the Investor. The Approved Securities will be either shares listed on the Australian Stock Exchange or units in widely held unit

trusts, as defined in section 272-105 in Schedule 2F to the 1936 Act. UBS Warburg will offer Investors a choice of Approved Securities. An Investor may choose to invest in a single Approved Security (for example, shares in a single company) or in a number of Approved Securities (for example, shares in two or more companies);

- (c) Where there is more than one Approved Security, the loan is segmented into tranches (each tranche separately being a 'Loan'). The tranches correspond to the amount applied to purchase each Approved Security;
- (d) UBS Warburg may offer a further loan to Investors to fund the payment of the interest payable on the Loan for the first (and in certain limited circumstances, the second) interest payment period (the 'Additional Loan'). Availability of the Additional Loan will be specified in the relevant term sheet (or may be agreed with UBS Warburg) and is subject to credit approval by UBS Warburg. The Additional Loan will be a full-recourse loan, repayable over a two year period in the case of a three year PEP, and over a three year period in the case of a PEP with a four or five year term. Interest on an Additional Loan is payable at the start of each interest payment period (which coincide with the interest payment periods under the Loan) during the term of the Additional Loan, at the interest rate set out in the Confirmation;
- (e) Clause 4.4 of the Loan Agreement provides an Investor with an option ('Put Option') to sell the Approved Securities for the amount outstanding under the Loan which relates to those Approved Securities. The Put Option may only be exercised by the Investor at maturity of the Loan. Each Put Option granted to the Investor may be exercised independently of each other Put Option (for example, if an Investor has a number of Approved Securities and one of the Approved Securities in the basket falls in value, the Investor can exercise their Put Option for that Approved Security, but need not exercise their Put Options for the other Approved Securities);
- (f) A portion of the interest payable on the Loan and the Additional Loan (if applicable) is allocated to the Put Option premium. The Put Option premium is based on the 'Put Option Premium Rate', which is the rate

published by UBS Warburg and applicable for the relevant interest payment period. This premium is no less than the excess of the interest rate charged on the Loan above the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans. The Put Option Premium Rate will be calculated as a percentage of the Interest Rate, and will vary depending on the term of the Loan;

- (g) The Loan and the Additional Loan are secured by a mortgage in favour of UBS Warburg over, amongst other things, the Approved Securities, any distributions paid or payable on the Approved Securities, the Put Option, any amount held by UBS Warburg on the Investor's behalf after sale of the Approved Securities in accordance with the trading facility and all other rights in respect of the Approved Securities;
- (h) The Loan by UBS Warburg to the Investor is a 'limited recourse' loan. Under the terms of the Loan Agreement, UBS Warburg's ability to recover the principal amount of the Loan is limited to either:
  - (i) if the Put Option is exercised by the Investor - the amount payable to the Investor under the Put Option; or
  - (ii) if the Put Option is not exercised by the Investor - the amount that UBS Warburg is able to obtain by enforcing its rights in respect of the mortgaged property.

In all other respects (for example, repayment of the principal amount of the Additional Loan and interest thereon, payment of interest on the Loan and any break costs) UBS Warburg's recourse against an Investor will not be limited.

- (i) Generally speaking, interest on the Loan is payable at or before the start of the relevant interest payment period, for example annually in advance. UBS Warburg may, however, stipulate that interest may be paid in arrears for one or more of the interest payment periods;
- (j) For each Loan or Additional Loan (as applicable), the interest rate for the first interest payment period will be set out in the applicable term sheet, or will be agreed with UBS Warburg, and will be confirmed in the Confirmation. Where there is more than one interest payment period (that is, for Loans of two, three, four or

- five years), the interest payable after the first interest payment period will be based on market rates at that time. Alternatively, the interest rate may be fixed from the start and apply throughout the term of the Loan or Additional Loan (as applicable);
- (k) On maturity of the Loan, the Investor has four alternatives:
- (i) repay the Loan and Additional Loan (if applicable) from their own funds, (which will result in a release of the mortgage over the Approved Securities);
  - (ii) extend the Loan for a further fixed term (if UBS Warburg makes this option available to the Investor) subject to the consent of UBS Warburg;
  - (iii) exercise the Put Option; and
  - (iv) if none of the above apply or the Investor applies to rollover the Loan where this alternative is not available, UBS Warburg may proceed to exercise its rights as mortgagee of the mortgaged property, and distribute surplus disposal proceeds, if any, to the Investor after repayment of the Loan and the Additional Loan, and any costs and expenses.
- (l) The Investor may repay the Loan or the Additional Loan (if applicable) prior to the repayment date. If this occurs, the Investor may be liable for additional break costs incurred by UBS Warburg as a result of the early unwinding of the PEP;
- (m) Any distributions paid to the Investor in respect of the Approved Securities will either be passed directly on to the Investor or will be held for the Investor by UBS Warburg or its nominee. Where distributions are held on the Investor's behalf, the Loan Agreement provides that such amounts will be used towards payment of the Investor's interest obligations to UBS Warburg. Any distributions remaining after an interest payment date may be released to the Investor. Where the Investor has an outstanding Additional Loan, such amounts may be applied towards payment of principal and interest on the Additional Loan;
- (n) The terms of the Loan Agreement allow, at UBS Warburg's discretion, limited trading of the Approved Securities during the term of the Loan. Under this

limited trading facility, Investors may sell and repurchase their Approved Securities (in accordance with the Loan Agreement), with any sale proceeds (after deducting costs associated with the trade) applied on the Investor's behalf to acquire units in a cash management trust or other trust satisfying the requirements of subparagraph 82KZME(5)(b)(iii) of the 1936 Act (the 'Approved Units'). The proceeds on disposal of the Approved Units may be used to repay the Loan or Additional Loan (if applicable), or to repurchase the Approved Securities under the trading facility. In addition, the Investor may be able to sell a call option over their Approved Securities to UBS Warburg under the limited trading facility;

- (o) At maturity, the Investor may choose to extend the Loan for a further period (if UBS Warburg makes this option available to the Investor) subject to UBS Warburg's consent. Any extension will not affect the mortgage over the Approved Securities.

### **The Participants**

12. UBS Warburg is the provider of the Loans and Additional Loans (if applicable) to Investors under the PEP to fund the acquisition of the Approved Securities. UBS Warburg also provides the Investor with the limited trading facility under the PEP.

13. The Investors may be individuals, companies or trusts.

### **Ruling**

---

14. Subject to the assumptions listed in paragraph 15 of this Ruling:

- (a) as part of the 'interest' charged under the Loan is a premium for a Put Option, it is a capital protection fee and is not deductible under section 8-1 of the 1997 Act;
- (b) the PEP interest charge allowable under section 8-1 of the 1997 Act is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or the relevant percentage of the total interest charge by UBS Warburg under the Loan Agreement as follows:
  - (i) 60% (for Loans with a term of one year);
  - (ii) 72.5% (for Loans with a term of two years);

- (iii) 80% (for Loans with a term of three years);
- (iv) 82.5% (for Loans with a term of four years); or
- (v) 85% (for Loans with a term of five years).

Where the interest rate charged on a Loan is a variable rate the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans Variable is to be used, and where the interest rate charged is a fixed rate the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans Fixed is to be used;

- (c) the amount of the interest on each Loan that is not deductible under the formula described in paragraph 14(b) above represents the payment of a premium for the Put Option by instalments and becomes part of the cost base of the Put Option under subsection 110-25(2) of the 1997 Act;
- (d) the interest charged on the Additional Loan is deductible under section 8-1 of the 1997 Act to the same extent that a deduction is allowable for the corresponding Loan interest (as described in paragraph 14(b) above). The non-deductible portion of the interest on the Additional Loan represents further consideration for the payment of the premium for the Put Option referred to in paragraph 14(b) above by instalments and is included in the cost base of the Put Option under subsection 110-25(2) of the 1997 Act;
- (e) section 51AAA of the 1936 Act will not apply to deny an Investor a deduction for the interest charge on their Loans or Additional Loans (if applicable) allowable under section 8-1 of the 1997 Act;
- (f) section 82KL, a specific anti-avoidance provision of the 1936 Act, will not apply to deny deductibility of the interest on the Loan or the Additional Loan allowable under section 8-1 of the 1997 Act;
- (g) section 82KZM of Subdivision H of Division 3 of Part III of the 1936 Act will not apply to deny the Investor immediate deductibility for the interest charge on the Loan or Additional Loan where at least one of the following applies for the year of income:
  - (i) the Investor is an STS taxpayer; or
  - (ii) the Investor is an individual taxpayer who does not incur the interest charge in carrying on a business.

- (h) sections 82KZMA, 82KZMB and 82KZMC of the 1936 Act will apply to determine the amount and timing of deductions for the PEP interest charge incurred by an Investor (other than an STS taxpayer for the year of income) who either:
  - (i) carries on a business; or
  - (ii) is a taxpayer that is not an individual and does not carry on a business.
- (i) section 82KZMF of the 1936 Act will not apply to set the amount and timing of deductions for the interest charge on the Loan;
- (j) section 82KZMF of the 1936 Act will not apply to set the amount and timing of deductions for the interest charge on the Additional Loan where the deductible portion of that interest is 'excluded expenditure' – that is, where the deductible interest amount on the Additional Loan (as calculated under the formula described in paragraph 14(b) above) is less than \$1,000 in a particular income year.

If the deductible portion of the interest on the Additional Loan is not deductible in full in the income year in which it is prepaid, the deductible amount is worked out using the formula in paragraph 82KZMF(1)(b) of the 1936 Act; and

- (k) the anti-avoidance provisions contained 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 Approved Securities or interest on the Additional Loan.

## **Assumptions**

---

15. 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 are not treated for taxation purposes as either trading in Approved Securities or carrying on a business of investing in Approved Securities. Further, the Investors do not otherwise hold the Approved Securities as revenue assets;

- (c) in respect of any interest charges to be paid in advance under the PEP Loan Agreement, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less and ends on or before the last day of the income year following the expenditure year;
- (d) the Investors will derive assessable income from the investment in the Approved Securities. That assessable income will not include income other than trust income, 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 Approved Securities;
- (f) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;
- (g) all dealings by the Investors and UBS Warburg will be at arm's length; and
- (h) the Investors will not prepay the Loan prior to maturity or terminate the arrangement early.

## **Explanations**

---

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

16. 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).

17. In the arrangement under this Product, part of interest payments under the Loan are allocated to the consideration for the Put Option (being the 'Put Option Premium'). The Put Option Premium ensures that the borrower is protected from liability to repay the principal if the market value of a tranche of Approved Securities falls below their original purchase price. In effect, the Put Option ensures that UBS Warburg will acquire the Approved Securities in full satisfaction of the Loan if the Approved Securities have fallen in value below the amount borrowed. Accordingly, the Put Option Premium is a capital protection fee and is not deductible under section 8-1

18. Part of the interest payments under the Additional Loan is also allocated to the Put Option Premium and that amount is not deductible under section 8-1.

19. 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. The fee is capital in nature, being paid to acquire an asset, namely, the Put Option.

20. Investors should only claim deductions equal to the amount of interest on the Loan and the Additional Loan determined as follows - the lower of the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or the applicable interest amounts as calculated in accordance with the formula described in paragraph 14(b) above.

21. That amount which is not deductible to the Investor under section 8-1 forms the cost base of a Put Option and constitutes an asset for capital gains tax purposes which is separate and in addition to the other rights created under the PEP as described in this Ruling.

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

22. Under the PEP it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income or trust 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 PEP.

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

23. 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.

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

24. 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, or amounts of expenditure that are of a capital nature.

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

25. 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.

26. 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***

27. The interest charge on the Loan and Additional Loan allowable under section 8-1 is in relation to a prepayment of loan interest for a period that is 12 months or less. 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, under the PEP is one year or less, and not to the period of the loan (except for a one year loan) which may be either one, two, three, four or five years for the Loan, and two or three years for the Additional Loan.

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

28. 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' type arrangement for the doing of a thing that is not to be wholly done within the expenditure year.

29. 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 PEP, including the financing, share purchase, share holding and disposal arrangements.

30. Exception 1, as contained in subsection 82KZME(5), applies to exclude the interest on the Loan from the operation of section 82KZMF, as:

- (a) the prepaid interest expenditure under the Loan is incurred in respect of money borrowed to acquire Approved Securities, being shares that are listed for quotation on the Australian Stock Exchange or units in a trust (as described in subparagraph 82KZME(5)(b)(iii));
- (b) the Investor can reasonably be expected to obtain dividends or trust income from the investment;
- (c) the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- (d) all aspects of the PEP are at arm's length,

31. Interest on the Additional Loan will not be interest on money borrowed to acquire the Approved Securities and, unlike interest on the Loan, will not fall within Exception 1. Where the amount of the interest prepayment on the Additional Loan that is deductible under section 8-1 is less than \$1,000, it will be 'excluded expenditure' (as defined under section 82KZL) and Exception 3 in subsection 82KZME(7) will apply, such that the deductible amount of the interest on the Additional Loan will be immediately deductible to the Investor.

32. If the deductible portion of the interest on the Additional Loan is not excluded expenditure, section 82KZMF of the 1936 Act will apply to set the amount and timing of deductions. Investors will be entitled to a deduction for this interest calculated using the formula set out in paragraph 82KZMF(1)(b).

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

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

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

and the expenditure is not excluded expenditure.

34. The section 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.

35. As the eligible service period for the Loan in relation to the deductible PEP interest is 12 months or less 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 allowable interest incurred under the Loan.

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

36. Sections 82KZMA, 82KZMB, 82KZMC and (in respect of income years after that 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:

- (a) carries on a business; or
- (b) is a taxpayer that is not an individual and that does not carry on a business.

The expenditure must not be excluded expenditure and must be either incurred in carrying on a business, or incurred otherwise than in carrying on a business by a taxpayer that is not an individual. The expenditure 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.

37. For these taxpayers, the prepaid interest on the Loan will be deductible on an accruals basis 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).

38. Section 82KZMD will not apply to an Investor in respect of interest payments on the Loan 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.

**Section 110-25 of the ITAA 1997: Cost Base of Put Option**

39. That amount of the interest charged on the Loan and the Additional Loan (if applicable) which is not deductible to the Investor under section 8-1 of the 1997 Act forms the cost base of a Put Option (under section 110-25(2) of the 1997 Act) which constitutes an asset for capital gains tax purposes that is separate and in addition to the other rights created under the PEP as described in this Ruling.

**Part IVA of the ITAA 1936**

40. 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**

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

	<b>Paragraph</b>
<b>What this Product Ruling is about</b>	<b>1</b>
Tax law(s)	3
Class of persons	4
Qualifications	5
<b>Date of effect</b>	<b>7</b>
<b>Withdrawal</b>	<b>9</b>
<b>Arrangement</b>	<b>10</b>
The Participants	12
<b>Ruling</b>	<b>14</b>
<b>Assumptions</b>	<b>15</b>
<b>Explanations</b>	<b>16</b>
Section 8-1 of the ITAA 1997	16
Section 51AAA of the ITAA 1936	22
Section 82KL of the ITAA 1936	23
Subdivision H of Division 3 of Part III of the ITAA 1936	24
<i>Subdivision 328-F &amp; G of the ITAA 1997 - STS taxpayer</i>	25
<i>The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936</i>	27

<i>Sections 82KZME and 82KZMF of the ITAA 1936 – prepaid expenditure and 'tax shelter' type arrangements</i>	28
<i>Section 82KZM of the ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure</i>	33
<i>Sections 82KZMA - 82KZMD of the ITAA 1936:- prepaid business expenditure incurred by non-STs taxpayers and prepaid non-business expenditure incurred by non-individual and non-STs taxpayers</i>	36
Section 110-25 of the ITAA 1997: Cost Base of Put Option	39
Part IVA of the ITAA 1936	40
<b>Detailed contents list</b>	<b>41</b>

**Commissioner of Taxation**

5 June 2002

<i>Previous draft:</i>	- ITAA 1936 82KZL(2)(a)
Not previously released in draft form	- ITAA 1936 82KZM
	- ITAA 1936 82KZMA
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZMB
TR 92/1; TR 92/20; TR 95/33,	- ITAA 1936 82KZMC
TR 97/16; TD 93/34; PR 1999/95	- ITAA 1936 82KZMD
	- ITAA 1936 82KZME
<i>Subject references:</i>	- ITAA 1936 82KZME(4)
- Financial products	- ITAA 1936 82KZME(5)
- interest expenses	- ITAA 1936 82KZME(5)(b)(iii)
- prepaid expenses	- ITAA 1936 82KZME(7)
- product rulings	- ITAA 1936 82KZMF
- public rulings	- ITAA 1936 82KZMF(1)(b)
- small business taxpayer	- ITAA 1936 Subdiv H
- taxation administration	- ITAA 1936 Div 3, Part III
- tax avoidance	- ITAA 1936 Pt IVA
	- ITAA 1936 272-105, Schedule 2F
<i>Legislative references:</i>	- ITAA 1997 8-1
- TAA 1953 Part IVAAA	- ITAA 1997 110-25(2)
- ITAA 1936 51AAA	- ITAA 1997 Subdiv 328-F
- ITAA 1936 82KL	- ITAA 1997 Subdiv 328-G
- ITAA 1936 82KZL(1)	

## ATO references:

NO: T2002/003381

ISSN: 1441 1172