PR 2002/89 - Income tax: deductibility of interest incurred on borrowings under the Leveraged Equities Share Protection Plan

Product Ruling
Income tax: deductibility of interest incurred on borrowings under the Leveraged Equities Share Protection Plan

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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.*

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

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 Leveraged Equities Limited ('LEL') 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 Leveraged Equities Share Protection Plan, which is referred to in this Ruling as 'the SPP'.

2. This ruling does not address the tax deductibility of interest (or other costs) incurred on a loan advanced against an existing portfolio of shares.

3. This ruling does not address the tax deductibility of interest (or other costs) incurred in respect to any other products promoted by LEL.

Tax law(s)

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

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- Division 108 of Part 3-1 (ITAA 1997);
- Division 110 of part 3-1 (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

5. 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

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

7. 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.

Date of effect

9. This Ruling applies prospectively from 12 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).

10. 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

11. 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

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

- Application for a Product Ruling dated 22 February 2002, amended documents and letters dated 6 and 20 May 2002 received from Deloitte Touche Tohmatsu;
- LEL's draft 'Share Protection Plan' brochure and application form with additional terms and conditions received from Deloitte Touche Tohmatsu on 20 May 2002;
- LEL's 'SPP Agreement' including the terms and conditions;
- LEL's 'SPP Notice'; and
- LEL's 'SPP Confirmation'.

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

(a) the SPP is a combined loan and Put Option product for which Investors pay an annual Interest Rate. The Interest Rate comprises the cost of borrowing and the Put Option premium rate. The total funding costs is the amount calculated by applying the Interest Rate to the amount of the relevant loan;

(b) under the SPP, Investors borrow funds from LEL to finance the purchase of a portfolio of securities in the Investor's own names ('SPP Securities'). Each Investor's portfolio of SPP Securities will consist of shares in a company selected by the Investor from a list of at least 50 Australian publicly listed companies specified by LEL ('Approved Securities');

(c) the minimum loan amount is $50,000 for a single share portfolio and a $100,000 minimum loan for a multiple share portfolio;

(d) the Interest Rate on the funds borrowed is a fixed interest rate as indicated on the SPP Confirmation . The interest rate on the SPP is based on a number of factors and varies from stock to stock. Generally, the longer the term the cheaper the overall interest rate;

(e) interest accrues daily, based on a 365 day year. Interest may be paid annually in advance or, alternatively, monthly in arrears;

(f) the term of the loan is either three years or five years;

(g) under the SPP, Investors also acquire a Put Option(s) from LEL. The rights under the Put Option are not transferable and not assignable without the written consent of LEL. The Put Option(s) may be exercised if, on the expiry date, the market value of a particular tranche of SPP Securities is less than the loan balance applicable to that tranche of SPP Securities. The Put Option, if exercised in respect of a tranche of SPP Securities, requires LEL to purchase the tranche of SPP Securities for the amount ('Exercise Price') of the loan balance of that tranche. The Exercise Price will be applied by LEL in satisfaction of the outstanding loan balance in respect of the particular tranche of SPP Securities;

(h) part of the Interest Rate comprises the Put Option premium. This is the greater of the excess on the interest charged on the loan above the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – fixed or the relevant percentage of the Interest Rate specified in paragraph 16(b) below;

(i) expenses in relation to the preparation, execution, amendment, enforcement and preservation of rights may be borne by the Investor. These may include, but are not limited to, share brokerage fees, stamp duty and Financial Institutions Duty on the purchase and sale of the Approved Securities;

(j) the Investor may trade the Investor's shares during the course of the loan. This is limited to two trades per annum. There is a $30,000 minimum trade in each stock for a $100,000 portfolio, and a $40,000 minimum trade in each stock for a portfolio greater than $100,000. Any proceeds from the sale of shares will be applied on the Investor's behalf to acquire units in a widely held unit trust of the type described in subsection 82KZME(5)(b)(iii) of the ITAA 1936 until the termination of the SPP or used to repurchase an identical number and type of shares;

(k) on expiry of the SPP, Investors may discharge their repayment obligations in several ways:

(i) repay the entire loan using their own funds and retain title to the SPP Securities;

(ii) where the market value of a particular tranche of SPP Securities is greater than the loan balance relating to that tranche at the expiry date, the Investor instructs their broker to dispose of the SPP Securities. In such a case the net proceeds of the sale will first be applied in repayment of the tranche of the loan applicable to those securities. The Investor will receive any amount by which the net proceeds of the disposal exceed the loan amount;

(iii) where the market value of a particular tranche of SPP Securities is less than the loan balance relating to that tranche at the expiry date, exercise the Put Option in respect of the particular tranche of shares, requiring LEL to acquire the SPP Securities in satisfaction of the loan balance in respect of that tranche of shares; or

(iv) convert the loan to a margin loan;

(l) as all SPP Securities that the Investor selects are held in the Investor's name, any dividends paid in respect of the SPP Securities are paid to the Investor; and

(m) 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.

The Participants

14. Under the SPP, LEL is the provider of the loan(s) and the Put Option.

15. Investors in the SPP may include individuals, companies and trusts.

Ruling

16. Subject to the assumptions listed in paragraph 17 of this ruling:

(a) as part of the funding cost charged under the SPP is a premium for a Put Option, it is a capital protection fee and is not deductible under section 8-1 of the ITAA 1997;

(b) the SPP interest charge allowable under section 8-1 of the ITAA 1997 is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – fixed or the relevant percentage of the total interest charge by LEL under the SPP Agreement as follows:

   (i) 80% (for Loans with a term of three years); or

   (ii) 85% (for Loans with a term of five years);

(c) the amount of the interest charged on the loan that is not deductible under the formula described above in paragraph 16(b) 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 ITAA 1997;

(d) section 51AAA of the ITAA 1936 will not apply to deny the SPP interest charge allowable under section 8-1 of the ITAA 1997;

(e) section 82KL, a specific anti-avoidance provision of the ITAA 1936, will not apply to deny deductibility of the SPP interest charge allowable under section 8-1 of the ITAA 1997;

(f) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the interest charge incurred;

(g) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of the SPP interest charge allowable under section 8-1 of the ITAA 1997 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 who does not incur the interest charge in carrying on a business;

(h) sections 82KZMA, 82KZMB, 82KZMC and 82KZMDof the ITAA 1936 will apply to set the amount and timing of deductions for the SPP interest charge that is deductible to 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; and

(i) the anti-avoidance provisions contained in Part IVA will not be applied to deny deductibility of the interest incurred by the Investor in respect of borrowings used to fund the purchase of SPP Securities.

Assumptions

17. 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 SPP Securities or carrying on a business of investing in SPP Securities. Further, the Investors do not otherwise hold the SPP Securities as revenue assets;

(c) in respect of any interest charges to be paid in advance under the SPP 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 SPP 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 SPP 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 LEL 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

18. 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).

19. 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 the SPP Securities falls below their original purchase price. In effect, the Put Option ensures that LEL will acquire the SPP Securities in full satisfaction of the loan if the SPP 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.

20. 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.

21. Investors should only claim deductions equal to the amount of interest on the loan determined as follows - the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – fixed or the applicable interest amounts as calculated in accordance with the formula described in paragraph 16(b) above.

22. 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 SPP as described in this Ruling.

Section 51AAA of the ITAA 1936

23. Under the SPP it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income and/or trust income as well as by way of capital gain. Accordingly, the interest would have been deductible under section 8-1 of the ITAA 1997 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 SPP.

Section 82KL of the ITAA 1936

24. 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

25. 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 and Subdivision 328-G of the ITAA 1997 – STS taxpayer

26. 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.

27. 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

28. The SPP interest charge on the loan allowable under section 8-1 of the ITAA 1997 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 SPP is one year or less, and not to the period of the loan which may be either three or five years.

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

29. 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.

30. 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 SPP, including the financing, share and/or unit purchase, share and/or unit holding and disposal arrangements.

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

(a) the prepaid interest expenditure under the SPP is incurred in respect of money borrowed to acquire 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 SPP are at arm's length.

Accordingly, the tax shelter prepayment rules will not apply to investors. Deductibility of the expenditure must therefore be considered under the prepayment rules outlined in paragraphs 32 to 37 below.

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

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

(a) an STS taxpayer for the year of income; or

(b) a taxpayer that is an individual and the expenditure is not incurred in carrying on a business;

and the expenditure is not excluded expenditure.

33. 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 of the ITAA 1997.

34. As the eligible service period in relation to the interest is 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 business expenditure incurred by non-STS taxpayers and prepaid non-business expenditure incurred by non-individual and non-STS taxpayers

35. 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.

36. For these taxpayers, the deduction for prepaid interest on the loan 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).

37. 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.

Part IVA of the ITAA 1936

38. Provided that the arrangement is entered into and carried out as disclosed (see paragraphs 12-15 above), it is accepted that the arrangement is a normal commercial transaction and Part IVA will not apply.

Detailed contents list

39. Below is a detailed table of contents list for this Product Ruling:

Commissioner of Taxation
12 June 2002

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

PR 2001/163; PR 1999/95; TR 92/1; TR 92/20; TR 97/11; TR 97/16; TD 93/34; TR 95/33; TR 98/22

Subject references:

- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- STS taxpayer
- taxation administration
- tax avoidance

Legislative references:

- TAA 1953 Part IVAAA
- ITAA 1936 51AAA
- ITAA 1936 82KL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZL(2)(a)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZMD
- ITAA 1936 82KZME
- ITAA 1936 82KZME(4)
- ITAA 1936 82KZME(5)
- ITAA 1936 82KZME(5)(b)(iii)
- ITAA 1936 82KZMF
- ITAA 1936 Pt IVA
- ITAA 1936 Schedule 2F
- ITAA 1936 272-105
- ITAA 1936 Subdiv H, Div 3, Part III
- ITAA 1997 8-1
- ITAA 1997 104-25(2)
- ITAA 1997 Div 108, Pt 3-1
- ITAA 1997 Div 110, Pt 3-1
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Subdiv 328-G

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