



PR 2003/51 - Income tax: deductibility of interest incurred on borrowings under the St.George Protected Loan

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 This document has changed over time. This is a consolidated version of the ruling which was published on *30 July 2003*



Product Ruling

Income tax: deductibility of interest incurred on borrowings under the St.George Protected Loan

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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.

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 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 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. Participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

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 persons who take 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 St.George Bank Limited ('St.George') to fund the acquisition of shares listed on the Australian Stock Exchange and/or units in a unit trust as described in subparagraph 82KZME(5)(b)(iii) of the *Income Tax Assessment Act 1936*, on the terms of a lending facility named the 'St.George Protected Loan'. The borrowing of money from St.George under the facility is referred to in this Ruling as 'the Loan', and the Loan together with the Put Option is referred to in this Ruling as the 'PL'.

2. The PL is available under the broader 'St. George Margin Lending' facility ('the Margin Lending Facility').

3. This Ruling does not address the tax consequences of:

- repaying the Loan using the limited recourse provisions;
- converting the PL to a standard margin loan;
- drawing down excess funds from the PL;
- extending the term of the PL at expiry time;
- early repayment or termination of the PL;
- trading in the Protected Securities prior to maturity;
- investing in stapled securities under the terms of the PL; and
- writing call options over securities using the Share Option Plan;

which are or may become available under the Margin Lending Facility.

4. This Ruling does not address an investor's entitlement to franking credits.

Tax law(s)

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

- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- subsection 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 82KZMD (ITAA 1936);
- section 82KZME (ITAA 1936);
- section 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

Class of persons

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

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

8. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner and it will be withdrawn or modified.

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Date of effect

10. This Ruling applies prospectively from 30 July 2003, 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).

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

Withdrawal

12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2007. 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

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

- application for a Product Ruling, as amended, received from Mallesons Stephen Jaques on behalf of St. George on 17 June 2003;
- the Terms & Conditions for a Protected Loan as set out in:
 - St. George Margin Lending Supplementary Terms & Conditions for a PL (the 'Loan Agreement'), as amended, received on 18 July 2003; and
 - to the extent applicable, St. George Margin Lending Facility Terms and Conditions, accompanying application for a Product Ruling dated 24 February 2003;
 - sample Protected Loan Identification Notice, as amended, received on 21 July 2003; and
 - additional information provided on 18 March 2003, 27 June 2003, 9 July 2003 and 18 July 2003.

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

- (a) the PL involves the granting of a put option (the 'Put Option') and the making of the Loan to the Investor;
- (b) the funds provided by St. George under the Loan are used to finance 100% of the purchase price of a portfolio of securities in the Investor's name ('Protected Securities');
- (c) the Protected Securities are selected by an Investor from a list provided by St. George. In this Ruling, the Protected Securities are shares listed on the Australian Stock Exchange and/or units in a trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936, which are not stapled securities;
- (d) the term of the Loan is fixed for either 1, 2, 3, 4 or 5 years, at the Investor's choice. The minimum Loan amount is \$40,000, and thereafter in additional increments of \$10,000 (or amounts that correspond to 1000 shares/units of the Protected Securities the Investor will acquire with the Loan proceeds);
- (e) the Loan Agreement provides the Investor with the Put Option to sell the Protected Securities to St. George for the amount of principal outstanding under the Loan which relates to those Protected Securities;

- (f) the Put Option may only be exercised by the Investor (or in limited circumstances by St.George or a nominee, on the Investor's behalf) at the time of the maturity of the Loan;
- (g) the rate of interest charged by St.George under the Loan varies according to the term of the Loan, with the shorter the period of the Loan and the more volatile the prices of the Protected Securities, the higher the rate of interest charged;
- (h) the interest rate on funds borrowed is fixed for the term of the Loan, and is payable either monthly or annually in advance;
- (i) a portion of the interest payable on the Loan is referable to the Put Option premium. This is the amount as calculated in paragraph 17(b);
- (j) subject to approval by St.George, Investors may repay the Loan prior to maturity. If this occurs, the Investor will not be able to exercise the Put Option or otherwise gain the benefit of the limited recourse provisions (addressed in paragraph 14(n)). The Investor will also not be entitled to a refund of the prepaid interest, and may be required to pay break costs;
- (k) subject to certain restrictions, the Investor may trade in the Investor's Protected Securities during the course of Loan. Any proceeds from the sale of Protected Securities will be applied on the Investor's behalf in a cash management trust account. An amount equal to the principal outstanding under the Loan (less the protected prices of any unsold Protected Securities acquired with the Loan proceeds) must remain in the cash management trust account until termination of the Loan, or that amount is otherwise used by the Investor to repurchase an identical type of securities;
- (l) no later than 7 days before the maturity date of the Loan, an Investor must elect to:
 - (i) repay the total amount owing on the Loan;
 - (ii) instruct St.George or a nominee to sell the Protected Securities and discharge the Loan on their behalf;
 - (iii) exercise their right under the Put Option to require St.George to purchase the Protected Securities;

- (iv) extend the term of the Loan (subject to St.George's consent);
- (v) convert the Loan to a standard margin loan; or
- (vi) if neither (i), (ii), (iii), (iv) or (v) applies, the Investor will be deemed to have nominated St.George or a nominee either:
 - (A) to exercise the Put Option on the Investor's behalf, requiring St.George to purchase the Protected Securities; or
 - (B) to sell the Protected Securities on their behalf and discharge the Loan;
- (m) if the Put Option is exercised by the Investor, the Protected Securities will be transferred to St.George for the principal amount outstanding under the Loan, and this will result in the discharge of the Loan;
- (n) provided the Loan is not repaid early and the Put Option is not exercised, the Loan will be a limited recourse loan. Under this term of the Loan, St.George is only entitled to enforce its rights as mortgagee in relation to the principal of the Loan against the Protected Securities (and certain of the Investor's rights in relation to those securities) held as security, or the net sale proceeds from the disposal of those securities;
- (o) expenses in relation to the acquisition, holding and disposition of the Protected Securities (including, but not limited to, brokerage) will be borne by the Investor, but these amounts will be physically paid by St.George on behalf of the Investor; and
- (p) this payment mechanism is facilitated by the Investor depositing amounts with St.George equal to 3% of the amount loaned, at the time the Loan is entered into. St.George will use this money to pay the expenses on behalf of the Investor in relation to the acquisition and disposal of Protected Securities on its behalf. Any part of the amounts that is not used by St.George will be credited to another loan account held by the Investor with St.George.

Participants

15. St.George is the provider of the Loans to Investors under the PL to fund the acquisition of the Protected Securities.
16. The Investors may be individuals, companies or trusts.

Ruling

17. Subject to paragraphs 3, 4 and 18 of this Ruling:
- (a) the PL interest charge allowable under section 8-1 of 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 charged by St. George as follows:
 - (i) for Loans with a term of 1 year, 60%;
 - (ii) for Loans with a term of 2 years, 72.5%;
 - (iii) for Loans with a term of 3 years, 80%;
 - (iv) for Loans with a term of 4 years, 82.5%; and
 - (v) for Loans with a term of 5 years, 85%;
 - (b) as the difference between the total interest charged on a PL and the deductible amount, as calculated in paragraph 17(a), is an instalment of the premium payable for the Put Option/s, that amount is not deductible under section 8-1 of the ITAA 1997 and becomes part of the cost base of the Put Option/s under subsection 110-25(2) of the ITAA 1997;
 - (c) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction for the PL interest charge allowable under section 8-1 of the ITAA 1997;
 - (d) section 82KL will not apply to deny deductibility of the PL interest charge 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 the PL interest charge;
 - (f) section 82KZM of the ITAA 1936 will not apply to deny an Investor immediate deductibility of that part of the PL interest charge allowable under section 8-1 of the ITAA 1997 where at least one of the following applies for the year of income:
 - (vi) the Investor is an STS taxpayer; or
 - (vii) the Investor is an individual who does not incur the interest charge in carrying on a business;

- (g) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for that part of the PL interest charge that is deductible to an Investor (other than an STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not carry on a business; and
- (h) the anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor on the Loan borrowings used to fund the purchase of Protected Securities.

Assumptions

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

- (a) 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 Protected Securities or carrying on a business of investing in the Protected Securities. Further, the Investors do not otherwise hold the Protected Securities as revenue assets;
- (c) interest charges paid in advance under the Loan may be prepaid only in relation to a loan interest payment period of 12 months or less, and which ends on or before the last day of the income year following the expenditure year;
- (d) the dominant purpose of an Investor entering into the arrangement is to derive assessable income comprising dividends or trust distributions and capital gains;
- (e) all dealings by Investors and St. George will be at arm's length; and
- (f) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling.

Explanation

Section 8-1 of the ITAA 1997

19. The ATO generally accepts that interest incurred to acquire shares or units in a trust that produce or may in the future produce income is deductible (Taxation Ruling TR 95/33).

20. Part of the interest charge under the PL is 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 Protected Securities falls below their original purchase price. The Put Option Premium is not deductible under section 8-1.

21. Investors should only claim deductions equal to the amount of interest on the Loan determined as follows - the lower of the applicable 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 17(a).

22. The amount which is not deductible to the Investor under section 8-1 is included within the cost base of the Put Option, which is an asset for capital gains tax purposes. This asset is separate and in addition to the other rights created under the PL as described in this Ruling.

Section 51AAA of the ITAA 1936

23. By entering into the PL, it is contemplated that an Investor will derive assessable income by the receipt of dividend or trust income and capital gains. As the interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a net capital gain in assessable income, section 51AAA has no application to an Investor in the PL.

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 a deduction 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 taxpayer is not an individual and incurs the expenditure otherwise than in carrying on a business. 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.

Subdivisions 328-F & 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 interest charge on the PL 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, and not to the period of the loan.

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 PL, including the financing, purchase, holding and disposal of the Protected Securities.

31. Exception 1, as contained in subsection 82KZME(5), applies to exclude the interest incurred 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 shares that are listed for quotation on the Australian Stock Exchange and/or units in a unit trust as described in subparagraph 82KZME(5)(b)(iii);
- (b) the Investor can reasonably be expected to obtain dividend 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 PL are at arm's length.

Deductibility of the expenditure must therefore be considered under the prepayment rules outlined in paragraphs 32 to 38 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.

33. 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.

34. As the eligible service period in relation to the deductible interest payment for the Loan 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 allowable interest incurred under the Loan.

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

35. Sections 82KZMA and 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.

36. 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.

37. For these Investors, the allowable deduction for prepaid interest on the borrowings under the Loan will be apportioned over the relevant interest payment period.

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

38. The amount of the interest charged on the Loan which is not deductible to the Investor under section 8-1 of the ITAA 1997 forms the cost base of the Put Option (pursuant to subsection 110-25(2)), which is an asset for capital gains tax purposes that is separate and in addition to the other rights created under the PL as described in this Ruling.

Part IVA of the ITAA 1936

39. Provided that the PL arrangement is entered into and carried out as disclosed in 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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Previous draft:

Not previously issued in draft form.

Related Rulings/Determinations:

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

Subject references:

- debt deductions
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- small business Investor
- 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 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 Subdiv H, Div 3, Pt III
- ITAA 1997 8-1
- ITAA 1997 110-25
- ITAA 1997 110-25(2)
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Subdiv 328-G
- Copyright Act 1968

ATO References

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