

PR 2003/6 - Income tax: Equity Margins Limited Protected Equity Investment Loan



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Product Ruling

Income tax: Equity Margins Limited Protected Equity Investment Loan

Contents	Para
What this Product Ruling is about	1
Date of effect	7
Withdrawal	9
Arrangement	10
Ruling	12
Explanations	14
Detailed contents list	35

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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 person who takes part in the arrangement to which this Ruling relates. In this Ruling the arrangement is the borrowing of moneys from Equity Margins Limited ('EML') to fund the acquisition of shares quoted on a stock market of a stock exchange approved in regulation 152N, Schedule 12 of the *Income Tax Regulations 1936* ('Australian shares' and 'foreign shares') and/ or units in widely held trusts as described in subsection 82KZME(5) of the *Income Tax Assessment Act 1936* ('Australian units' and 'foreign units') on the terms of the 'Protected Equity Investment Loan' facility which is referred to in this Ruling as the 'PEIL'.
2. This ruling does not address the tax consequences of funding the prepayment of interest or establishment fee for the PEIL arrangement by the drawdown of existing equity margin loans.

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 25-25 of the ITAA 1997;
 - section 820-35 of the ITAA 1997;
 - section 820-37 of the ITAA 1997;
 - section 820-40 of the ITAA 1997;
 - section 820-85 of the ITAA 1997;
 - section 820-185 of the ITAA 1997;
 - section 820-300 of the ITAA 1997;
 - section 820-395 of the ITAA 1997;
 - section 960-335 of the ITAA 1997;
 - section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 79D of the ITAA 1936;
 - section 82KZM of the ITAA 1936;
 - section 82KZMA of the ITAA 1936;
 - section 82KZMB of the ITAA 1936;

- section 82KZMC of the ITAA 1936;
- section 82KZMD of the ITAA 1936;
- section 82KZME of the ITAA 1936
- section 82KZMF of the ITAA 1936; and
- Part IVA of the 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 this Ruling is materially different from this arrangement that is actually carried out:

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- (b) the Ruling will be withdrawn or modified.

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Date of effect

7. This Ruling applies prospectively from 12 March 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).

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 2006. The Ruling continues to apply, in respect of the tax laws relied 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:

- a) application for a Product Ruling dated 1 May 2002 and amended application for a Product Ruling dated 11 November 2002;
- b) the Protected Equity Investment Loan Terms & Conditions attached to the amended application dated 11 November 2002 consisting of;
 - i) Loan terms;
 - ii) Mortgage terms;
 - iii) Sponsorship terms;

- iv) Nominee terms; and
- v) General terms (including definitions).
- c) additional information provided on 12 December 2002 and 14 February 2003.

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

- a) under the PEIL arrangement, the Investor borrows funds from EML to finance the purchase of 'Approved Stocks' in the Investor's name. In this Ruling, Approved Stocks are shares and units that are approved by EML. The shares will be quoted on a stock market of a stock exchange approved in regulation 152N, Schedule 12 of the *Income Tax Regulations* 1936 ('Australian shares and foreign shares'). The units will be units in a trust that has at least 300 beneficiaries and is a widely held trust as described in subsection 82KZME(5) of the ITAA 1936;
- b) the term of the loan is for a period of 12 months or such other term agreed between the Investor and EML. Where no security is provided by the Investor, the amount of the loan shall be 100% of the value of an investment in a single Approved Stock or a portfolio. Where security, in the form of Approved Stocks or cash, is provided by the Investor, the amount of the loan, as agreed by EML, may be less than 100% of the value of the investment in a single Approved Stock or portfolio. Any cash provided by the Investor will be used to purchase Approved Stocks;
- c) when an Investor provides security, they will receive a lower rate of interest. Interest is payable in advance and is not refundable. The prepayment of interest is expected to be for a period of 12 months, however, it could vary where agreement has been reached between EML and the Investor;
- d) the rate of interest charged by EML to customers borrowing under the PEIL varies according to the term of the loan offered, security provided, and the type of Approved Stocks purchased. The interest rates are fixed for the period of the loan. At present the interest rate can vary from around 12 % p.a. to 19 % p.a.;
- e) borrowing expenses in the form of an establishment fee of 1% of the amount of the loan will apply;

- f) for the purposes of securing the rights of EML under the PEIL, the Investor shall deal with the Approved Stocks as stated in the Mortgage terms;
- g) the facility may be terminated early by organising EML to sell the Approved Stocks and repaying the borrowed funds;
- h) Clause 7 of the Loan terms provides for a limited recourse facility. EML is only entitled to enforce its rights as mortgagee in relation to the principal of the loan against the Approved Stocks held as security. When the loan matures, if the value of the Approved Stocks is below the amount of the loan from EML, the Investor may notify that they will repay the loan by transferring the Approved Stocks to EML. The Investor is never required to repay the difference between the market value of the Approved Stocks and the principal borrowed. Upon maturity of the loan, Investors may:
 - i) repay the loan in full using their own funds;
 - ii) repay the loan from the proceeds of the sale of the Approved Stocks;
 - iii) satisfy the loan by the transfer of the Approved Stocks; or
 - iv) refinance the loan.
- i) any dividends or trust distributions paid in respect of the Approved Stocks purchased under the PEIL are paid to the Investor.

Ruling

12. Subject to the assumptions in paragraph 14:
- a) section 8-1 of the ITAA 1997 will apply to allow the Investor a deduction for the interest charged under the terms of the PEIL;
 - b) section 25-25 of the ITAA 1997 will apply to allow the Investor to deduct the borrowing expenses, in the form of an establishment fee, paid over the lesser of the period of the loan or 5 years;
 - c) section 51AAA of the ITAA 1936 will not apply to deny the Investor a deduction of the interest allowable under section 8-1 of the ITAA 1997;

- d) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the interest charge incurred under the PEIL;
- e) section 82KZM of the ITAA 1936 will not apply to deny the Investors immediate deductibility of any part of their interest payable under the PEIL where at least one of the following applies for the year of income:
 - i) the Investor is a Simplified Tax System (STS) taxpayer; or
 - ii) the Investor is an individual who does not incur the interest charge in carrying on a business;
- f) sections 82KZMA, 82KZMB, 82KZMC and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for that part of the PEIL 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;
- g) section 820-85 of the ITAA 1997 will not be applied to disallow any part of the interest or establishment fee paid under the PEIL;
- h) section 820-185 of the ITAA 1997 will not be applied to disallow any part of the interest or establishment fee paid under the PEIL;
- i) section 820-300 of the ITAA 1997 will not be applied to disallow any part of the interest or establishment fee paid under the PEIL;
- j) section 820-395 of the ITAA 1997 will not be applied to disallow any part of the interest or establishment fee paid under the PEIL;
- k) section 79D of the ITAA 1936 will not apply to quarantine the interest or establishment fee relating to investments in foreign shares or units; and
- l) the general anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not apply to deny the deductibility of the interest incurred in respect of borrowings to purchase the Approved Stocks.

Assumptions

13. The assumptions in reaching these conclusions are as follows:
- a) the Investors are Australian residents;
 - b) the Investors are not traders in investments and would not be treated for taxation purposes as either trading in the Approved Stocks or carrying on a business of investing in the Approved Stocks. Further, the Investors do not otherwise hold the Approved Stocks as revenue assets;
 - c) the Investor will not be defined (or group classified) as an outward investing entity (non-‘ADI’), where ‘ADI’ is defined in section 995-1 of the ITAA 1997;
 - d) the Investor will not be defined (or group classified) as an inward investment vehicle (general or financial);
 - e) the Investor will not be defined (or group classified) as an outward investing entity (‘ADI’);
 - f) the Investor will not be defined (or group classified) as an inward investing entity (‘ADI’);
 - g) the interest that is prepaid by Investors is paid for a maximum period of 12 months or less that ends on or before the last day of the income year following the expenditure year;
 - h) the dominant purpose of the Investor entering into the arrangement is to derive assessable income comprising dividends or trust distributions and capital gains;
 - i) the foreign shares or units will be interests in foreign investment funds that are exempt under a general or specific exemption under Part XI of the ITAA 1936;
 - j) the Investor will not be an attributable taxpayer under Part X of the ITAA 1936 in relation to its holding in the foreign shares or units;
 - k) all dealings by Investors and EML will be at arm’s length; and
 - l) the arrangement will be executed in the manner described in the ‘Arrangement’ section of this Ruling.

Explanations

Section 8-1 of the ITAA 1997 - Deductibility of interest

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

15. As a consequence, the interest payable under a PEIL should be fully deductible under section 8-1.

Section 25-25 of the ITAA 1997 - Deductibility of borrowing expenses

16. The establishment fee is expenditure incurred for borrowing under the PEIL. As the funds are used exclusively for income producing purposes, the borrowing expenditure will be deductible under section 25-25 over the lesser of the term of the loan or 5 years.

Section 51AAA of the ITAA 1936

17. By investing in the PEIL, it is contemplated that an Investor will derive assessable income by the receipt of dividend or trust income and capital gains. 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. Accordingly, section 51AAA has no application to an Investor in the PEIL.

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

18. 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, whether the Investor is not an individual and incurs the expenditure otherwise than in carrying on a business 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.

Subdivisions 328-F & 328-G of the ITAA 1997 - STS taxpayer

19. 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.

20. 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

21. The interest charge under the PEIL 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

22. The rules in section 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.

23. 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 PEIL, including the financing, share or unit purchase, share or unit holding and disposal arrangements.

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

- a) the prepaid interest expenditure under the PEIL, is incurred in respect of money borrowed to acquire shares that are listed for quotation on an approved stock exchange as set out in section 82KZME(5) and/or to acquire units in a trust that has at least 300 beneficiaries and is a widely held unit trust as defined in section 272-105 in Schedule 2F of the ITAA 1936;
- 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 PEIL are at arm's length.

25. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 26 to 32 below.

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

26. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by an Investor 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.

27. 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.

28. As the eligible service period in relation to the deductible interest payment under the PEIL 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 PEIL interest incurred.

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

29. Sections 82KZMA, 82KZMB, 82KZMC and (in respect of income years after the income year 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 an Investor that is not an individual and does not incur the expenditure in carrying on a business.

30. 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.

31. For these Investors, the deduction for prepaid interest on the borrowings under the PEIL 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).

32. Section 82KZMD will not apply to an Investor in respect of interest payments on the borrowings under the PEIL 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 820-35, 820-37, 820-40, 820-85, 820-185, 820-300 and 820-395 of the ITAA 1997 - Thin Capitalisation

33. Generally, an Australian resident investing offshore through a PEIL arrangement will not be subject to the thin capitalisation measures if:

- a) the annual 'debt deduction' of the Investor and associate entities do not exceed the de minimis limit of \$ 250,000 per annum. Debt deductions include interest and application fees, which in this Ruling is defined as the establishment fee, payable under a PEIL;
- b) the foreign assets of the Investor and associate entities do not exceed the asset threshold test of 10% of total assets (comprising Australian and foreign assets);
- c) the Investor's or associate entity's offshore activities do not give rise to an overseas permanent establishment, or offshore investment if they are not in a controlled foreign entity. It is not likely that the PEIL would give rise to an overseas permanent establishment; or

- d) the Investor is not an Australian entity that is foreign controlled, either directly or indirectly through associate entities.

Section 79D of the ITAA 1936 - Limitation of Deductions for Foreign Income

34. Interest payable and the establishment fee paid in relation to foreign shares and units is not quarantined under section 79D, as debt deductions are excluded from the definition of foreign income deductions in subsection 160AFD(9) of the ITAA 1936. Interest should only be quarantined to the extent that it relates to an overseas permanent establishment, which would not be relevant here.

Part IVA of the ITAA 1936 - General Anti-Avoidance

35. Provided that the PEIL 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

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

	Paragraph
What this Product Ruling is about	1
Tax law(s)	3
Class of persons	4
Qualifications	5
Date of effect	7
Withdrawal	9
Arrangement	10
Ruling	12
Assumptions	13
Explanations	14
Section 8-1 of the ITAA 1997 - Deductibility of interest	14
Section 25-25 of the ITAA 1997 - Deductibility of borrowing expenses	16
Section 51AAA of the ITAA 1936	17

Subdivision H of Division 3 of Part III of the ITAA 1936	18
<i>Subdivisions 328-F & 328-G of the ITAA 1997 - STS taxpayer</i>	19
<i>The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936</i>	21
<i>Sections 82KZME and 82KZMF of the ITAA 1936: prepaid expenditure and 'tax shelter' arrangements</i>	22
<i>Section 82KZM of the ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure</i>	26
<i>Sections 82KZMA - 82KZMD of the ITAA 1936: prepaid non-business expenditure incurred by non-individual and non-STS taxpayers</i>	29
Sections 820-35, 820-37, 820-40, 820-85, 820-185, 820-300 and 820-395 of the ITAA 1997 - Thin Capitalisation	33
Section 79D of the ITAA 1936 - Limitation of Deductions for Foreign Income	34
Part IVA of the ITAA 1936 - General Anti-Avoidance	35
Detailed contents list	36

Commissioner of Taxation

12 March 2003

Previous draft:

Not previously released 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:

- borrowing expenses
- debt deductions
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- small business Investor
- taxation administration
- tax avoidance
- thin capitalisation

Legislative references:

- ITR 1936 152N, Sch 12

- TAA 1953 Part IVAAA
- ITAA 1936 51AAA
- ITAA 1936 79D
- 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 82KZMF
- ITAA 1936 Div 3H, Pt III
- ITAA 1936 160AFD(9)
- ITAA 1936 Part IVA
- ITAA 1936 Part X
- ITAA 1936 Part XI
- ITAA 1936 Sch 2F, 272-105
- ITAA 1997 8-1
- ITAA 1997 25-25
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Subdiv 328-G

- ITAA 1997 820-35
- ITAA 1997 820-37
- ITAA 1997 820-40
- ITAA 1997 820-85
- ITAA 1997 820-185
- ITAA 1997 820-300
- ITAA 1997 820-395
- ITAA 1997 960-335
- ITAA 1997 995-1

ATO References

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