

PR 2004/76 - Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment plus



This cover sheet is provided for information only. It does not form part of *PR 2004/76 - Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment plus*



This document has changed over time. This is a consolidated version of the ruling which was published on *10 May 2006*



Product Ruling

Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment plus

Contents	Para
What this Product Ruling is about	2
Date of effect	10
Withdrawal	12
Arrangement	13
Ruling	18
Assumptions	19
Explanation	20
Detailed contents list	49

Preamble

*The number, subject heading, **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 IVA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a 'public ruling' and how it is binding on the Commissioner.*

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

No guarantee of commercial success

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.

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 grant of a Put Option and the borrowing of moneys from Macquarie Bank Limited ('the Bank') to fund the acquisition of shares listed on the Australian Stock Exchange ('ASX') and/or units of a widely held unit trust, referred to in this Ruling as 'Approved Securities', on the terms of a lending and investment facility named the 'Macquarie Geared Equities Investment plus' ('GEI plus'). A call option may also be granted by the borrower under the Shared Upside feature for a reduced rate of interest ('Call Option').

2. This Ruling does not address the tax consequences of a loan advanced against an existing portfolio of shares.

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

- converting the GEI plus loan to a Margin Loan;
- the Limited Trading feature;
- the Refinancing feature;
- the Protection Reset feature;
- the Switching feature; and
- the Covered Calls feature;

which are available under the terms of the GEI plus and described in the Combined Product Disclosure Statement and Financial Services Guide dated June 2004. Interest deductions under section 8-1 of the ITAA 1997 for the amounts referred to in paragraphs 18(a) and 18(c) are available to the Investor up to the time that the Investor uses one or more of the features listed above.

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);
- section 104-10 of the ITAA 1997;

- paragraph 104-25(1)(c) of the ITAA 1997;
- Division 110 of the ITAA 1997;
- Division 134 of the ITAA 1997;
- section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 82KL of the ITAA 1936;
- section 82KZM of the ITAA 1936;
- section 82KZMA 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

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, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

9. 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:

Commonwealth Copyright Administration
Intellectual Property Branch
Department of Communication, Information Technology and
the Arts

GPO Box 2154
Canberra ACT 2601

or by e-mail: commonwealth.copyright@dicta.gov.au

Date of effect

10. This Ruling applies prospectively from 9 June 2004, 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).

Note: The Addendum to this Ruling that issued on 10 May 2006, applies on and from 10 May 2006.

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 dated 25 March 2004 received from Horwath (Vic) Pty Ltd on behalf of Macquarie Bank Limited; and
- the GEI plus Combined Product Disclosure Statement and Financial Services Guide dated June 2004.

14. Unless otherwise defined, capitalised terms in this product ruling have the same meaning as in the Combined Product Disclosure Statement and Financial Services Guide.

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

- (a) under the GEI plus, the Investor borrows funds from the Bank to finance the purchase of certain Approved Securities. The Approved Securities are shares listed on the ASX or units in certain widely held listed trusts. Where the Approved Security is a stapled security, the stapled security comprises share/s and unit/s that are jointly listed for quotation on the ASX;
- (b) the Investors are required to select Approved Securities up to the amount of funds borrowed from the Bank from a list of Approved Securities which is provided to the Investor when they receive the GEI plus application form. The minimum loan amount is \$50,000 with subsequent drawings and/or purchases being in parcels of at least \$50,000;
- (c) the term of the GEI plus loan may be one, two, three, four or five years. Interest is payable monthly in arrears on a variable or fixed basis. Alternatively, Investors may fix their interest rate for 1 or more years and pay interest annually in advance for a 12 month period;
- (d) the Bank will calculate a different rate of interest for each Approved Security an Investor may invest in. The interest rate will be quoted and reported to an Investor as a single consolidated rate taking into account all of the shares held. The interest rate will also depend upon the term of the GEI plus loan. The shorter the period of the GEI plus loan and the greater the risk to the Bank given the security offered by the Approved Securities, the higher the rate of interest charged;
- (e) Investors may also choose to enter into an Interest Prepayment Loan with the Bank for the purpose of funding the payment of prepaid interest on a GEI plus loan. The term of each Interest Prepayment Loan equals the term of the prepaid interest period on the GEI plus loan and is limited to 12 months. The interest rate on an Interest Prepayment Loan will be determined by the Bank at the time of drawdown of the particular Interest Prepayment Loan. The Interest Prepayment Loan is repayable by way of twelve monthly in arrears principal and interest repayments over the prepaid interest period on the GEI plus loan immediately succeeding the date the Interest Prepayment Loan is borrowed. Under the Interest Prepayment Loan there is no limitation on the recourse

- of the lender. Repayment of the Interest Prepayment Loan prior to its maturity date may incur break costs;
- (f) for the purpose of securing the rights of the Bank under the GEI plus, the Investor grants a mortgage to the Bank over the acquired Approved Securities and related rights;
 - (g) The GEI plus Loan and Security Agreement provides for a limited recourse facility through the grant of a Put Option by the Bank to the Investor. As such, the Bank is only entitled to enforce its rights as mortgagee in relation to the principal of the GEI plus loan against the Approved Securities held as security;
 - (h) the Put Option operates to give the Investor the right to transfer to the Bank the Approved Securities purchased with the GEI plus loan where the market value of those Approved Securities has fallen below the acquisition cost of those Approved Securities. The price payable by the Bank to the Investor for that transfer of Approved Securities is the amount of the GEI plus loan borrowed by the Investor to purchase such Approved Securities. The Bank is entitled to set-off the payment of that price against the obligations of the Investor to repay the GEI plus loan;
 - (i) a portion of the interest payable under the GEI plus loan and the Interest Prepayment Loan (if applicable) is allocated to the Put Option premium. The Put Option premium is no less than the excess of the interest rate charged on the GEI plus loan above the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans. The Put Option premium will be calculated as a percentage of the interest rate, and will vary depending on the term of the GEI plus loan;
 - (j) the GEI plus also contains a Shared Upside feature. Under this feature, the Investor grants to the Bank a Call Option to purchase the Approved Securities when the GEI plus loan matures if the value of the Approved Securities increases to an amount in excess of 150% of the original purchase price;
 - (k) Investors must choose at the time of entering into the Loan and Security Agreement whether or not they will grant the Call Option under the Shared Upside feature. If an Investor selects to enter into the Call Option, they will be charged a lesser interest rate in relation to the GEI plus loan than would have been applicable if the Shared Upside feature had not been selected;
 - (l) if an Investor elects to enter into the Shared Upside feature, they must also choose, prior to GEI plus loan

drawdown, what percentage of increase in the value of the Approved Securities in excess of 150% of the original purchase price will be used to calculate the Exercise Price (being the amount payable on the exercise of the Call Option) or the 'Interest Reduction Fee'. An Investor may select 0%, 25%, 50% or 100% as the relevant percentage. The level of reduction of the interest rate in relation to the GEI plus loan will depend on the level of percentage nominated for the purposes of the Call Option – the larger the percentage, the larger the interest rate reduction on the GEI plus loan;

- (m) no fee is charged by the Investor when it grants the Call Option to the Bank;
- (n) the Exercise Price payable by the Bank to the Investor on exercise of the Call Option is calculated as:

$$I + (P \times MV)$$

where:

I = an amount representing 150% of the Market Value of the Relevant Securities as at the date of grant of the Call Option;

P = the Nominated Percentage; and

MV = that part of the Market Value of the Relevant Securities in excess of I as at the Exercise Date;

- (o) if upon maturity of the GEI plus loan the market price of the Approved Securities is in excess of 150% of the original purchase price, the Investor may cash settle the Call Option arrangement rather than transferring ownership of the Approved Securities to the Bank;
- (p) where the Investor chooses to cash settle the Call Option, it must repay the GEI plus loan in full using its own funds (being either personal or borrowed funds). In these circumstances, the Investor must also pay to the Bank using its own funds the Interest Reduction Fee calculated as:

$$SG - (I + (P \times MV))$$

where:

SG = the Market Value of the Relevant Securities at the date that is 3 Business Days prior to the Final Maturity Date;

I = an amount representing 150% of the Market Value of the Relevant Securities as at the date of the Call Option;

P = the Nominated Percentage; and

MV = that part of the Market Value of the Relevant Securities in excess of I as at the Exercise Date;

- (q) the Investor shall repay the GEI plus loan to the Bank in one amount on Final Maturity Date. At least five clear Business Days before the Final Maturity Date the Investor must inform the Bank whether:
 - (i) the Investor will repay all or part of the loan on Final Maturity Date; and/or
 - (ii) the Investor intends to exercise the Put Option; and/or
 - (iii) the Investor requests the loan be converted to a Margin Loan facility; and/or
 - (iv) the Investor intends to refinance the GEI plus and extend the term of all or part of their loan;
- (r) any dividends or distributions paid in respect of the Approved Securities purchased under the GEI plus are paid to the Investor;
- (s) any dividends paid during the period of the GEI plus loan and reinvested as part of a Reinvestment Plan will initially form part of the security for the GEI plus loan and will be retained by the Investor at the expiry of the GEI plus loan; and
- (t) bonus shares issued will form part of the security for the GEI plus. At the expiry of the GEI plus loan, should the market value of the original shares, and any bonus shares, be below the cost of the original parcel of Approved Securities, both the original and bonus shares may be subject to the Put Option.

The participants

16. The Bank is the provider of GEI plus loans to Investors to fund the acquisition of Approved Securities and Interest Prepayment Loans under the GEI plus.

17. The majority of investors will be individuals. There will also be investors using companies or trusts to make an investment in the GEI plus.

Ruling

18. Subject to paragraphs 2, 3, 4 and 19 of this Ruling:

- (a) the GEI plus 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 or the relevant

percentage of the total interest charged by the Bank under the GEI plus as follows:

- (i) 60% (for GEI plus loans with a term of one year);
- (ii) 72.5% (for GEI plus loans with a term of two years);
- (iii) 80% (for GEI plus loans with a term of three years);
- (iv) 82.5% (for GEI plus loans with a term of four years); or
- (v) 85% (for GEI plus loans with a term of five years);

where the interest rate charged on a GEI plus 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;

- (b) the difference between the total interest charged by the Bank and the amount allowable as a deduction under paragraph 18(a) is not allowable as a deduction under section 8-1 of the ITAA 1997. This non deductible amount 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;
- (c) the interest charge on the Interest Prepayment Loan is deductible under section 8-1 of the ITAA 1997 to the same extent that the deduction is allowable for the corresponding GEI plus loan interest charge (as described in paragraph 18(a));
- (d) the non-deductible portion of the interest charge on the Interest Prepayment Loan represents further consideration for the payment of the premium for the Put Option referred to in paragraph 18(b) by instalments and is included in the cost base of the Put Option under subsection 110-25(2) of the ITAA 1997;
- (e) section 51AAA of the ITAA 1936 will not apply to deny the deductibility of the interest charge under the GEI plus loan or the Interest Prepayment Loan (if applicable) allowable under section 8-1 of the ITAA 1997;
- (f) section 82KL will not apply to deny deductibility of the interest allowable as a deduction under section 8-1 of the ITAA 1997 incurred under the GEI plus loan or the Interest Prepayment Loan (if applicable);

- (g) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the interest charge allowable as a deduction under section 8-1 of the ITAA 1997 incurred under the GEI plus loan;
- (h) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of the interest charge on the GEI plus loan allowable under section 8-1 of the ITAA 1997, where at least one of the following applies for the year of income:
 - the Investor is an STS taxpayer; or
 - the Investor is an individual who does not incur the interest charge in carrying on a business;
- (i) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for the interest charge on the GEI plus loan 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;
- (j) if the Investor exercises the Put Option at the end of the loan term, the cost of acquiring the Put Option will be added to the cost base of the Approved Securities under section 134-1 of the ITAA 1997. Any gain or loss on exercise of the Put Option will be disregarded;
- (k) if the Investor does not exercise the Put Option, the Investor will make a capital loss equal to the reduced cost base of the Put Option;
- (l) the grant of the Call Option by the Investor to the Bank under the Shared Upside feature, is a CGT event which does not result in a capital gain or a capital loss;
- (m) if the Bank exercises the Call Option granted under the Shared Upside feature and the Investor transfers Approved Securities to it, CGT event A1 will happen and the Investor will make a capital gain equal to the capital proceeds received from the Bank less the Investor's cost base in the Approved Securities. The proceeds received by the Investor from the Bank will be the market value of the Approved Securities less the percentage of the increase the Investor has agreed to forgo. The proceeds will thus equate to the Exercise Price;
- (n) if the Investor repays the GEI plus loan and sells Approved Securities to fund the repayment, the Investor will make a capital gain on selling the Approved Securities equal to the sale proceeds less the cost base of the Approved Securities;
- (o) if, at the Maturity Date, the Investor repays the GEI plus loan but retains the ownership of the Approved

- Securities, the payment of the Interest Reduction Fee based on the agreed percentage of increase in value of the Approved Securities in excess of 150% of purchase price will form part of the cost base of the Approved Securities for CGT purposes; and
- (p) the anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor in respect of the GEI plus loan used to fund the purchase of Approved Securities or in respect of the Interest Prepayment Loan.

Assumptions

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

- (a) all of the Investors are Australian residents for taxation purposes;
- (b) the Investors are not traders in investments and are not treated for taxation purposes as trading in the Approved Securities, carrying on a business of investing in the Approved Securities, or holding the Approved Securities as trading stock or as revenue assets;
- (c) in respect of any interest charges to be paid in advance under the GEI plus loan, these 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) at all times during an arrangement, where the Approved Securities includes units in a trust, the trust satisfies the requirements of subparagraph 82KZME(5)(b)(iii);
- (e) the dominant purpose of an Investor in entering the arrangement is to derive assessable income from their Approved Securities acquired under the GEI plus, comprising dividends or trust distributions and capital gains;
- (f) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling; and
- (g) all dealings by the Investors and the Bank under the GEI plus will be at arm's length.

Explanation

Section 8-1 of the ITAA 1997

20. The cost (or interest paid) of a borrowing used to acquire income producing assets such as shares or units in a trust is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

21. Investors should only claim deductions equal to the amount of interest on the GEI plus loan and the Interest Prepayment Loan (if applicable) 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 18(a).

22. The difference between the total interest charged on the GEI plus loan and the Interest Prepayment Loan (if applicable) and the amount deductible under section 8-1 is the amount of interest allocated to the cost of the Put Option (the Put Option premium). The payment of the Put Option Premium ensures that the borrower is protected from liability to repay the principal if the market value of the Approved Securities acquired under the GEI plus falls below their original purchase price. In effect, the Put Option ensures that the Bank 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.

Section 51AAA of the ITAA 1936

23. Under the GEI plus 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. As the interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a capital gain, section 51AAA has no application to an Investor in the GEI plus.

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 Investor 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) of the ITAA 1936 to include amounts of less than \$1,000 or amounts 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 interest charge under the GEI plus loan deductible 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) of the ITAA 1936 provides that a payment of interest that is made in return for the making available of a loan principal is to be taken, for the purposes of Subdivision H, to be expenditure incurred under an agreement in return for the doing of a thing under the agreement for the period to which the interest payment relates. The eligible service period in relation to a payment of loan interest is determined by reference to the period to which the interest relates and not to the period of the GEI plus loan.

Sections 82KZME and 82KZMF of the ITAA 1936: prepaid expenditure and 'tax shelter' type 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' type 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 GEI plus, 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 amount of interest allowable as a deduction under section 8-1 of the ITAA 1997 on borrowings under the GEI plus loan from the operation of section 82KZMF, as:

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

Deductibility of the prepaid interest must therefore be considered under the prepayment rules obtained in paragraphs 32 to 37.

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:

- an STS taxpayer for the year of income; or
- is 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 payments for the GEI plus 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 interest amount allowable as a deduction under section 8-1 incurred on the GEI plus.

Sections 82KZMA and 82KZMD of the ITAA 1936: prepaid non-business expenditure incurred by non-individual and non-STS 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 an Investor 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 taxpayers, the amount of prepaid interest allowable as a deduction under section 8-1 of the ITAA 1997 incurred on the GEI plus loan will be apportioned over the relevant interest payment period.

Put Option and Cost Base

38. The cost of the capital protection is not deductible to the Investor under section 8-1 of the ITAA 1997 (refer to paragraphs 18(b), 18(d) and 22) and is included in the cost base of the Put Option acquired by the Investor pursuant to subsection 110-25(2) of the ITAA 1997. The Put Option constitutes an asset for CGT purposes and is separate and in addition to the other rights created under the GEI plus as described in this Ruling.

39. If the Investor exercises the Put Option at the end of the GEI plus loan term by transferring title to the Approved Securities to the Bank in satisfaction of the GEI plus loan, any gain or loss on exercise of the Put Option is disregarded (subsection 134-1(4) of the ITAA 1997). The Investor will add the payment for acquiring the Put Option to the cost base of the Approved Securities disposed to the Bank (subsection 134-1(1), item 2 of the ITAA 1997).

40. If the investor does not exercise the Put Option by the Maturity Date, the Investor will make a capital loss at that time, equal to the cost base of the Put Option (CGT Event C2, paragraph 104-25(1)(c) of the ITAA 1997).

Shared Upside – Call Option

41. Under the arrangement the Investor grants the Bank a Call Option which may be exercised when the GEI plus loan matures if the market price of the Approved Securities is greater than 150% of the purchase price. If the Call Option is exercised, the Investor is required to transfer the Approved Securities to the Bank at the agreed

Exercise Price or cash settle the Call Option obligations by paying the Interest Reduction Fee to the Bank.

42. The grant of the Call Option by the investor to the Bank will not result in a capital gain or loss arising for the Investor.

43. Before the Bank issues the Call Option Notice, the Investor can elect to either:

- (a) transfer ownership of the Approved Securities to the Bank; or
- (b) cash settle the Call Option obligations.

44. Where the Investor chooses to transfer ownership of the Approved Securities to the Bank, CGT event A1 will happen in relation to the disposal of the Approved Securities. Where the capital proceeds of the disposal exceed the cost base of the Approved Securities, the Investor will make a capital gain. The cost base for the Approved Securities will include the purchase price.

45. The capital proceeds the Investor receives when they deliver their Approved Securities will be the market value of the Approved Securities less the percentage of the increase the Investor has agreed to forgo (the Exercise Price). The percentage forgone will equate to the Interest Reduction Fee.

46. Alternatively, the Investor may choose to cash settle the Call Option and repay the GEI plus loan by:

- (a) selling the Approved Securities themselves and using these funds to repay the GEI plus loan;
- (b) not selling the Approved Securities but using their own funds to repay the GEI plus loan; or
- (c) borrowing further funds from the Bank and refinancing the original GEI plus loan.

47. If the Investor does not sell the Approved Securities, but uses their own funds or borrows to repay the GEI plus loan, or refinances the original loan, the Investor will be required to pay the Interest Reduction Fee to the Bank. This payment is capital expenditure made to preserve the Investor's title to the Approved Securities and it will form part of the Approved Securities' cost base (subsection 110-25(6) of the ITAA 1997).

Part IVA of the ITAA 1936

48. Provided that the arrangement ruled on is entered into and carried out as disclosed (see the Arrangement part of this Ruling), it is accepted that the arrangement is an ordinary commercial transaction and Part IVA will not apply.

Detailed contents list

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

	Paragraph
What this Product Ruling is about	1
Tax law(s)	5
Class of persons	6
Qualifications	7
Date of effect	10
Withdrawal	12
Arrangement	13
The participants	16
Ruling	18
Assumptions	19
Explanation	20
Section 8-1 of the ITAA 1997	20
Section 51AAA of the ITAA 1936	23
Section 82KL of the ITAA 1936	24
Subdivision H of Division 3 of Part III of the ITAA 1936	25
<i>Subdivision 328-F and Subdivision 328-G of the ITAA 1997 – STS taxpayer</i>	26
<i>The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936</i>	28
<i>Sections 82KZME and 82KZMF of the ITAA 1936: prepaid expenditure and 'tax shelter' type arrangements</i>	29
<i>Section 82KZM of the ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure</i>	32
<i>Sections 82KZMA and 82KZMD of the ITAA 1936: prepaid non-business expenditure incurred by non-individual and non-STs taxpayers</i>	35
Put Option and Cost Base	38
Shared Upside – Call Option	41
Part IVA of the ITAA 1936	48
Detailed contents list	49

Commissioner of Taxation

9 June 2004

Previous draft:

Not previously issued in draft form

Related Rulings/Determinations:

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

Subject references:

- debt deductions
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- small business investor
- taxation administration
- tax avoidance

Legislative references:

- TAA 1953 Pt IVA
- ITAA 1936 51AAA
- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- 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 1997 8-1
- ITAA 1997 104-10
- ITAA 1997 104-25(1)(c)
- ITAA 1997 Div 110
- ITAA 1997 110-25(2)
- ITAA 1997 110-25(6)
- ITAA 1997 Div 134
- ITAA 1997 134-1
- ITAA 1997 134-1(1), item 2
- ITAA 1997 134-1(4)
- ITAA 1997 Subdiv 328-F
- ITAA 1997 Subdiv 328-G
- Copyright Act 1968

ATO References

NO: 2003/2427

ISSN: 1441-1172