



PR 2004/81 - Income tax: tax consequences of investing in the Provident Capital Retirement Booster Debenture

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 This document has changed over time. This is a consolidated version of the ruling which was published on *11 August 2004*



Product Ruling

Income tax: tax consequences of investing in the Provident Capital Retirement Booster Debenture

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Potential participants may wish to refer to the Tax Office's website at **www.ato.gov.au** or contact the Tax Office directly to confirm the currency of this Product Ruling or any other Product Ruling that the Tax Office has issued.

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 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 Tax Office 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 and how the product fits an existing portfolio. We recommend you make your own enquiries regarding such matters (eg consult a financial planner or accountant and relevant Government agencies).

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out 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, 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 Tax Office 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 law(s)' 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 acquisition of a Provident Capital Retirement Booster Debenture ('the Debenture') using funds provided by a Loan ('the Loan') made by Provident Capital.
2. This Ruling does not address the tax consequences of:
 - interest incurred on interest that is capitalised under the arrangement; or
 - interest or Loan establishment fees incurred to the extent that the Loan funds under the arrangement are used for a purpose other than acquiring the Debenture; or
 - the redemption of the Debenture.

Tax law(s)

3. The tax laws dealt with in this Ruling are:
 - section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 8-1 of the ITAA 1997;
 - section 25-25 of the ITAA 1997; and
 - Part IVA of the *Income Tax Assessment Act 1936* (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 with the 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.

6. 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.

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Date of effect

8. This Ruling applies prospectively from 11 August 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).

9. 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, the Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

10. This Product Ruling is withdrawn and ceases to have effect after 30 June 2007. The Ruling continues to apply, in respect of the tax law(s) 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

11. The arrangement that is the subject of this Ruling is specified below. This arrangement incorporates the following documents:

- Application for Product Ruling dated 9 September 2003 and additional information provided on 10 October 2003;
- Provident Capital Mortgage Memorandum, undated;
- Retirement Booster Loan Agreement ('the Loan Agreement') undated;
- Executive Summary, undated;
- Draft wording for inclusion in the Retirement Booster Debenture Prospectus; and
- Provident Capital Limited Debenture Prospectus 5 dated 15 November 2002.

Note: Certain information received from the applicant has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information legislation.

12. The arrangement involves a back to back loan/debenture offer. Investors enter into the Loan Agreement with Provident Capital to purchase the Debenture. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which an Investor, or an associate of an Investor, will be a party to that form part of the arrangement to which this Ruling applies.

13. To be eligible to enter into the arrangement, applicants must be over 60 years of age, own their own home and occupy it as their main residence ('the Property'). The arrangement may be entered into by either individuals or multiple applicants, where a home is owned jointly. Where there are joint applicants then all parties must be over the age of 60.

The Loan

14. The minimum amount that can be borrowed under the Loan Agreement is \$50,000. The total amount that may be borrowed will depend on a number of factors including:

- the age of the Investor(s);
- the value and location of the Property; and
- the amount of the Loan that will be used to purchase the Debenture.

15. If the Property is not owned outright, the Loan proceeds must be used to discharge any current debt. At least 50% of the Loan proceeds must be used to acquire the Debenture. The Investor(s) may use the remainder of the Loan proceeds for whatever purpose the Investor(s) determine(s).

16. There is no fixed term for the arrangement. The interest rate on the Loan is fixed at the time the arrangement is entered into (see paragraph 20). The interest accruing on the Loan will be capitalised and therefore only becomes payable, along with the principal, on the termination of the arrangement.

17. There is a once only Loan establishment fee of \$880 incurred at the time the arrangement is entered into by the Investor(s). Other than stamp duty and any other government charges, there are no other fees or charges payable in respect of the arrangement.

18. Provident Capital will register a mortgage over the Property. The mortgage is issued on standard industry terms. In addition, Provident Capital will take a charge over the Debenture.

19. The recourse that Provident Capital has to the assets of the Investor(s) in recovering the amount of the Loan is limited, as set out at paragraph 31.

The Debenture

20. Interest is payable on the Debenture as provided for under the Debenture Prospectus. As is the case with the Loan, the interest payable on the Debenture is fixed at the time that the arrangement is entered into, being at a rate 1.5% lower than the interest payable on the Loan.

21. Interest earned on the Debenture will be payable to the Investor(s) monthly and may be used by the Investor(s) in any way that they determine. Interest from the Debenture is not required to be offset against the Loan balance.

22. The Debenture may be redeemed by the Investor(s) at any time to the Debenture issuer, Provident Capital Limited, for its face value ('the Redemption Amount'). Apart from this, the Debenture cannot be disposed of or traded, i.e., it cannot be sold or transferred to another person.

Termination of the Arrangement

23. The arrangement is terminated at the earliest of the following times:

- when the Debenture is redeemed;
- when the Property is sold;
- when the Property ceases to be the main residence of the Investor(s);
- when the Investor dies, or, in the case of joint owners, when the Investor who is the last surviving joint owner dies;
- when a Default Event occurs; and

- when the Loan is repaid.

24. A Default Event is defined in the Loan Agreement and includes, but is not limited to, the Investor not doing something required under the agreement or making a statement in relation to the arrangement which is false or misleading.

25. Where the Debenture is redeemed, the Redemption Amount will immediately be applied to reduce the Loan account balance. Where the Redemption Amount is less than the Loan account balance, the shortfall must be paid by the Investor(s) within 3 months of redemption of the Debenture.

26. Where the Property is sold, the Debenture will be redeemed and the Redemption Amount will be applied to reduce the Loan account balance. Where the Redemption Amount is less than the Loan account balance, the shortfall must be paid out of the proceeds of the sale of the Property.

27. Where the Property ceases to be the main residence of the Investor(s), Provident Capital must be notified within 3 months of this happening. Upon notification, the Debenture will be redeemed and the Redemption Amount will be applied to reduce the Loan account balance. Where the Redemption Amount is less than the Loan account balance, the shortfall must be paid within 3 months of redemption.

28. Where the Investor or the last surviving Investor dies, in the case of multiple Investors, the Debenture will be redeemed and the Redemption Amount will be applied to reduce the Loan account balance. Where the Redemption Amount is less than the Loan account balance, the shortfall must be paid by the relevant Investor's estate within 6 months of the death of that Investor.

29. Where a Default Event occurs, as defined in the Loan Agreement, the Debenture will be redeemed and the Redemption Amount will be applied to reduce the Loan account balance. Where the Redemption Amount is less than the Loan account balance, the shortfall must be repaid immediately.

30. In any case where the value of the Debenture is greater than the Loan account balance (for example, where the arrangement is terminated because the Loan is repaid), the difference will be paid to the Investor(s) or their estate(s) within 1 month of the termination of the arrangement.

31. Provident Capital's recourse to the Investor(s) assets under the Loan is limited to recovering the aggregate of the amount realised by the sale of the Property plus the value of the Debenture. If the aggregate amount is less than the Loan account balance, Provident Capital will not sue for the shortfall from the Investor(s) or their estate(s), except where:

- there has been fraud or dishonesty on the part of the Investor(s) or their estate;

- the mortgage does not effectively create a first ranking mortgage as intended by the Loan Agreement; or
- the Investor(s) allows a Default Event under the Loan Agreement to happen.

Ruling

32. Interest received from the Debenture acquired under the arrangement will be assessable income under section 6-5 of the ITAA 1997.

33. Interest incurred on that part of the Loan that is applied to acquire the Debenture under the arrangement will be allowable as a deduction under section 8-1 of the ITAA 1997, but only to the extent of the interest received from the Debenture.

34. The difference between the interest incurred on that part of the Loan that is applied to acquire the Debenture and the interest received from the Debenture is not deductible under section 8-1 of the ITAA 1997 (see example at paragraph 60).

35. A deduction for the Loan establishment fee is allowable under section 25-25 of the ITAA 1997, to the extent that the Loan is applied to acquire the Debenture, over the shorter of 5 years or the period starting on the day the arrangement is entered into and ending on the day the Loan is repaid.

36. The anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not be applied to deny deductibility of the interest or Loan establishment fee incurred in respect of the borrowings used to fund the purchase of the Debenture.

Assumptions

37. This Ruling is made on the basis of the following assumptions:
- (a) the dominant purpose of the Investor(s) is not to obtain a tax benefit from their investment in the Debenture;
 - (b) all dealings by the Investor(s) and Provident Capital will be at arm's length; and
 - (c) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling.

Explanation

Section 6-5 of the ITAA 1997 – Assessability of interest received under the Debenture

38. Interest received from the Debenture acquired under the arrangement is ordinary income. Therefore, the interest will be assessable income under section 6-5 of the ITAA 1997.

Section 8-1 of the ITAA 1997 – Deductibility of interest in relation to funds used to acquire the Debenture

39. Interest incurred on borrowings used to acquire income producing assets such as shares in a company, units in a unit trust or a debenture, is generally treated as deductible under section 8-1 of the ITAA 1997 where it is expected that assessable income would be derived from the investment (see Taxation Ruling TR 95/33). Under the arrangement, the Investor(s) borrow money, some of which is used to invest in an income producing asset being the Debenture.

‘Incurred’

40. The Investor(s) have no immediate requirement to pay interest on the Loan. Instead interest accrued will be capitalised on the Loan account balance and no repayments are required until the arrangement is terminated. This raises the question of whether interest is incurred by the Investor(s) under the arrangement.

41. The leading authority on the meaning of ‘incurred’ is *FCT v. James Flood Pty Ltd* (1953) 5 AITR 579, where it was established that a liability is incurred if there is a presently existing liability. It is not necessary that the sum in question be presently payable nor that it has been paid.

42. The liability to pay interest under the arrangement is calculated on a daily basis with the interest added to the Loan balance on a monthly basis. The interest is therefore incurred as it accrues notwithstanding that payment is not actually required until a later time.

43. This Ruling does not deal with the tax consequences of interest incurred to the extent that it relates to that part of the Loan which reflects capitalised interest (‘interest on interest’).

Limits on Deductibility

44. Section 8-1 of the ITAA 1997 states that you can deduct from your assessable income a loss or outgoing to the extent that it relates to gaining or producing assessable income.

45. This Ruling only deals with the tax consequences of that part of the interest on the Loan that relates to the acquisition of the Debenture. Apart from discharging existing debt in relation to the

Property, the rest of the Loan proceeds may be used for any purpose, as determined by the Investor(s). The deductibility of interest on this part of the Loan will depend on the use and purpose to which these funds are put.

46. In relation to the interest on the Loan funds used to acquire the Debenture, the High Court in *Fletcher & Ors v. FC of T* (1991) 173 CLR 1 (*'Fletcher'*) at 18-19 stated:

....it is commonly possible to characterise an outgoing as being wholly of the kind referred to in the first limb of s 51(1) without any need to refer to the taxpayer's subjective thought processes. That is ordinarily so in a case where the outgoing gives rise to the receipt of a larger amount of assessable income.....

.....The position may, however, well be different in a case where no relevant assessable income can be identified or where the relevant assessable income is less than the amount of the outgoing.....

Where that is so, it is a "**commonsense**" or "**practical**" **weighing of all the factors which must provide the ultimate answer**: see eg BP Australia Ltd v FCT [1966] AC 224 at 264; 112 CLR 386; 9 AITR 615; Hallstroms Pty Ltd v FCT (1946) 72 CLR 634 at 648; 3 AITR 436; FCT v Foxwood (Tolga) Pty Ltd (1981) 147 CLR 278 at 285, 293; 11 ATR 859; 35 ALR 1. If, upon consideration of all those factors, it appears that, notwithstanding the disproportion between outgoing and income, the whole outgoing is properly to be characterised as genuinely and not colourably incurred in gaining or producing assessable income, the entire outgoing will fall within the first limb of s 51(1) [emphasis added]

47. The High Court proceeded to hold that it is appropriate to examine the whole circumstances of an arrangement, encompassing the direct and indirect objectives sought by entering into the arrangement, where the assessable income derived from the arrangement is to be less than the relevant outgoings.

48. The High Court continued at CLR 19; (see also paragraph 6 of TR 95/33):

If...that consideration reveals that the disproportion between outgoing and relevant assessable income is essentially to be explained by reference to the independent pursuit of some other objective and that part only of the outgoing can be characterised by reference to the actual or expected production of assessable income, apportionment of the outgoing between the pursuit of assessable income and the pursuit of that other objective will be necessary.

49. The main purpose of entering the arrangement for the Investor(s) is to generate an income stream to assist in funding their retirement through the freeing up of the equity in their home.

50. Apart from the interest payable under the Debenture, there will be no other assessable income derived that will have the relevant nexus to that part of the interest incurred on the Loan that is attributable to the acquisition of the Debenture. Therefore, this amount of interest will exceed the amount of assessable income derived from the Debenture.

51. The willingness to accept the disproportion between the interest incurred and the interest earned in these circumstances is explained by the Investor(s) desire to access and utilise the equity in their home in order to fund their retirement.

52. Therefore, applying the principles in *Fletcher* and TR 95/33, a deduction for the interest incurred under the arrangement, to the extent that it relates to those funds used to acquire the Debenture, is limited to the amount of income received under the Debenture.

Section 25-25 of the ITAA 1997 – Deductibility of the Loan establishment fee as a borrowing expense

53. Subsection 25-25(1) of the ITAA 1997 allows a deduction for expenditure incurred by the taxpayer for borrowing money to the extent that the borrowed money is used for the purpose of producing assessable income.

54. The Loan establishment fee is an expense of borrowing money. Under subsections 25-25(1) and 25-25(3) of the ITAA 1997, it will be deductible to the extent that the Loan proceeds are used to purchase the Debenture under the arrangement. For instance, if 60% of the Loan is used to purchase the Debenture, then 60% of the Loan establishment fee will be allowable as a deduction over the relevant period.

55. This Ruling only deals with the tax consequences with that part of the Loan establishment fee that relates to the acquisition of the Debenture. Apart from discharging existing debt in relation to the Property, the rest of the Loan proceeds may be used for any purpose, as determined by the Investor(s). The deductibility of the Loan establishment fee on this part of the Loan will depend on the use and purpose to which these funds are put.

56. The period of the Loan is not known at the time the arrangement is entered into. Therefore, under subsection 25-25(5) of the ITAA 1997, the deduction is allowable over 5 years or the period starting on the first day on which the money was borrowed and ending on the day the Loan is repaid, whichever is the shorter.

57. The maximum amount of the deduction that can be claimed in any income year is calculated under subsection 25-25(4) of the ITAA 1997. This amount is obtained by dividing the maximum amount of undeducted expenditure at that point in time (that is, assuming that a deduction has been allowed in any earlier income years based on the borrowed money being solely used to produce assessable income) by the number of days remaining in the relevant Loan period and multiplying the result by the number of days in the Loan period that are in the income year.

58. The percentage representing the extent to which the Loan funds are applied to acquire the Debenture (see paragraph 52 above) is then applied to this amount to work out the deduction in any given income year.

Part IVA of the ITAA 1936

59. 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 a normal commercial transaction entered into by the Investor(s) predominantly for the purpose of accessing and utilising the equity in their home in order to fund their retirement, with part of that funding being provided by the generation of an income stream. Therefore, Part IVA of the ITAA 1936 will not apply to the arrangement.

Example

60. Jean is 68. She owns and occupies her own home as her main residence, but still has \$5,000 outstanding on her existing mortgage. She decides to apply for Provident Capital's Retirement Booster. Her home is valued at \$500,000

61. Jean decides to borrow \$75,000 and invest \$50,000 in a Debenture. She enters into the arrangement on 1 May 2004. The Debenture interest rate is fixed at 8% per annum and is payable on the 28th day of each month. The interest rate on the Loan is fixed at 9.5%. The Loan establishment fee is \$880. The funds borrowed will be used as shown in the table:

Discharge Existing Mortgage	\$5,000
Purchase a Debenture	\$50,000
Loan Establishment Fee	\$880
Available for other purposes	\$19,120
Total Proceeds	\$75,000

62. Interest accumulates at 9.5% on the Loan each month and after 5 years the Loan balance will have increased to \$119,430. If there is a corresponding property growth rate of 3% per annum after 5 years, the value of Jean's property will have increased to \$579,637.

63. Jean will receive regular monthly income from the Debenture of \$333.33 (\$4,000 per annum). When she prepares her 2004 tax return Jean will have to include \$667 (that is, 2 months @ \$333.33) in her assessable income under section 6-5 of the ITAA 1997.

64. Simple interest on the Loan in the first year is \$7,125 (9.5% x \$75,000). Two-thirds of the Loan funds are applied to acquire the Debenture, so \$4,750 of interest is attributable to the acquisition of the Debenture. Over the 2 months to June 2004, \$792 of interest will be incurred in relation to the acquisition of the Debenture. As this is greater than the interest derived under the Debenture, Jean's entitlement to a deduction for interest under section 8-1 of the ITAA 1997 is limited to \$667 (see paragraph 33).

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65. Jean is also entitled to a deduction for the borrowing expenses (Loan establishment fee) incurred in setting up the arrangement (section 25-25 of the ITAA 1997). Jean's deduction is calculated using the method prescribed in subsection 25-25(4) of the ITAA 1997:

Year	Unclaimed Borrowing Expenses	Eligible Days/total days remaining in loan period	Maximum deduction	Percentage used to purchase Debenture	Deduction Allowable
2004	880	61/1826	29	66.67%	20
2005	851	365/1765	176	66.67%	117
2006	675	365/1400	176	66.67%	117
2007	499	365/1035	176	66.67%	117
2008	323	365/670	176	66.67%	117
2009	147	305/305	147	66.67%	98
Total			880		587

Detailed contents list

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Commissioner of Taxation

11 August 2004

Previous draft:

Not previously issued as a draft

*Related Rulings/Determinations:*PR 1999/95; TR 92/1; TR 92/20;
TR 95/33; TR 97/16; TD 93/34*Subject references:*

- financial products
- interest expenses
- product rulings
- public rulings
- taxation administration

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 8-1

- ITAA 1997 25-25

- ITAA 1997 25-25(1)

- ITAA 1997 25-25(3)

- ITAA 1997 25-25(4)

- ITAA 1997 25-25(5)

- ITAA 1936 51(1)

- ITAA 1936 Pt IVA

- TAA 1953 Pt IVAAA

- Copyright Act 1968

Case references:- FCT v. James Flood Pty Ltd
(1953) 5 AITR 579- Fletcher & Ors v. FC of T (1991)
173 CLR 1

ATO references

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