



# ***PR 2005/78 - Income tax: tax consequences of investing in the Commonwealth Bank Protected Portfolio Loan***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *25 May 2005*



## Product Ruling

# Income tax: tax consequences of investing in the Commonwealth Bank Protected Portfolio Loan

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Potential participants may wish to refer to the Tax Office website at [www.ato.gov.au](http://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 a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out 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**

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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 the Commonwealth Bank of Australia (the Bank) under the terms of a lending and investment facility named the 'Commonwealth Bank Protected Portfolio Loan' (the PPL). The borrowings are used to fund the acquisition of shares listed on the Australian Stock Exchange (ASX) and/or units of a widely held unit trust. A call option may also be granted by the borrower under the Reduced Interest Rate 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;
  - extending the term of the PPL from the original maturity date or rolling-over the PPL into another form of financing;
  - the Protection Reset feature;
  - using the Portfolio Management feature of the PPL;
  - the Covered Calls feature; and
  - the early repayment and termination of the PPL,

which are available under the terms of the PPL and described in the draft Product Disclosure Statement dated 5 May 2005.

3. Upon maturity of a loan under the PPL, an investor may in certain situations extend the term of the loan. Alternatively, an investor may seek to roll-over the funding represented by a loan into another type of financing provided by the Bank, including but not limited to any then available variation of the PPL. The tax implications of any such extension or roll-over are not addressed in the Ruling. However, the Ruling is applicable to the arrangement until the time of any such extension or roll-over.

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;
  - section 104-25 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.

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## Date of effect

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10. This Ruling applies prospectively from 25 May 2005, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

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

## Withdrawal

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12. This Product Ruling is withdrawn and ceases to have effect after 30 June 2008. 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

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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 31 March 2005 received from Greenwoods & Freehills Pty Limited on behalf of the Bank; and
- draft Product Disclosure Statement Protected Portfolio Loan (PDS) dated 5 May 2005.

14. Unless otherwise defined, capitalised terms in this Product Ruling have the same meaning as in the PDS.

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

- (a) the PPL is a combination of a loan and Put Option. The limited recourse loan from the Bank is used by the Investor to finance 100% of the purchase price of a portfolio of shares and / or units listed on the ASX (Approved Securities) plus the applicable Brokerage. Where the Approved Securities include a stapled security, the stapled security comprises share/s and unit/s that are jointly listed for quotation on the ASX;
- (b) the Investor selects from a range of Approved Securities that the Bank has approved for inclusion in the PPL (Securities). The Investor grants a mortgage to the Bank over the Securities as security for the PPL;
- (c) the minimum loan amount is \$50,000.00. The minimum amount for an individual Security is \$10,000.00;
- (d) Investors can choose from fixed terms of 1, 2, 3, 4 or 5 years only;
- (e) the Interest Rate on the PPL is determined by the Bank taking into account a number of factors which are set out in the PDS. A different Interest Rate will generally apply for each Parcel of Securities. Where the Investor selects more than one Parcel of Securities, the Interest Rate will be the single weighted average Interest Rate that takes into account all of the Parcels of Securities selected;
- (f) Interest Payments on the PPL are payable by the Investor at either:
  - a Fixed Interest Rate – annually in advance;
  - a Fixed Interest Rate – monthly in arrears; or
  - a Variable Interest Rate – monthly in arrears;
- (g) subject to certain conditions, including the Bank's agreement, an Investor may elect to change their Interest Payment method from:
  - a Variable Interest Rate (monthly in arrears) to a Fixed Interest Rate (annually in advance or monthly in arrears); and
  - vice versa.

If an Investor elects to change their Interest Payment method from a Fixed Interest Rate paid annually in advance to monthly in arrears, or change to a Variable Interest Rate, this election can only be made at the end of the period that is the subject of the Fixed Interest Rate;

- (h) under the PPL, the Bank also grants to the Investor a Put Option giving the Investor the right to transfer a purchased Parcel of Securities to the Bank for the option price equal to the principal outstanding under the loan in respect of those Securities (Protected Price). Unless instructed otherwise, the Bank is authorised by the Investor to exercise the Put Option if on the Final Maturity Date the Market Value of any of the Parcel of Securities is below their Protected Price;
- (i) a portion of the Interest Payments under the PPL is attributable to the Put Option premium. This is the amount as calculated in paragraph 18(b) of this Ruling;
- (j) the PPL is a limited recourse loan. As such, where the Investor fails to repay the PPL on the Final Maturity Date the Bank is only entitled to recover what is owing by selling the Securities sold to it under the Put Option or enforcing its rights as mortgagee against the Securities held as security;
- (k) the PPL also contains a Reduced Interest Rate feature. This feature allows an Investor to obtain a reduced rate of interest by agreeing to limit their entitlement to the capital growth of their Securities. Under the Reduced Interest Rate feature:
  - (i) the Investor grants the Bank a Call Option to purchase the Parcel of Securities at the Call Option Price at the Final Maturity Date of the PPL. The Call Option must have the same maturity date as the PPL;
  - (ii) the Call Option Price is calculated according to the amount of capital growth the Investor agrees to forgo by choosing the relevant Capped Rate and Participation Rate;
  - (iii) the Participation Rate allows the Investor to forgo some or all of the capital growth of the Parcel of Securities above the Capped Price. The Participation Rate will determine the percentage that the Investor will receive from any capital growth of the Parcel of Securities above the Capped Price. The Capped Price must be set above the Protected Price of the Securities and is determined by multiplying the Capped Rate (being a percentage greater than 100%) by the Protected Price of the Securities. The same Capped Rate and the Participation Rate must be applied to each Parcel of Securities under the PPL;

- (iv) Investors must choose at the time of entering into the PPL whether or not they will utilise the Reduced Interest Rate feature;
- (v) granting of the Call Option will result in the Investor being charged a lesser Interest Rate with regard to the PPL that would have been applicable if the Reduced Interest Rate feature had not been used. The reduction in the Interest Rate will depend on the Capped Rate and Participation Rate chosen;
- (vi) if the Bank exercises the Call Option at the Final Maturity Date of the PPL, the Investor must transfer the relevant Parcel of Securities to the Bank;
- (vii) an Investor may also choose to cash settle the Call Option at the Final Maturity Date of the PPL in the event where a Call Option is exercised by the Bank. This results in a release of mortgage over the Parcel of Securities provided that the Investor pays the following to the Bank in full:
  - (A) the PPL; and
  - (B) an amount equal to the difference between the Call Option Price and the Market Value of the Parcel of Securities; and
- (viii) the Bank will only exercise the Call Option at the Final Maturity Date of the PPL if the Market Value of the Parcel of Securities is equal to or above the Capped Price. Where the Market Value of the Parcel of Securities is less than the Capped Price, the Bank will not exercise the Call Option on the Final Maturity Date;
- (l) on the Final Maturity Date, the Investor shall settle the PPL. If the Investor has utilised the Reduced Interest Rate feature and the Call Option is exercised, the following alternatives are available:
  - (i) sell all or some of the Securities to the Bank at the Call Option Price. The Bank will apply these proceeds on the Investor's behalf to repay their PPL and any surplus will be forwarded to the Investor;
  - (ii) use their own funds to repay the PPL and keep the relevant Securities. The Investor must pay the Bank the difference between the Call Option Price and the Market Value of the Parcel of Securities;

- (iii) extend the Term of the PPL by applying for a new loan (subject to availability and credit approval). The Investor will need to pay the Bank the difference between the Call Option Price and the Market Value of the Parcel of Securities; or
- (iv) a combination of the above;
- (m) alternatively, if the Investor has not utilised the Reduced Interest Rate feature, the Investor has to inform the Bank at least five Business Days prior to the Final Maturity Date of the PPL how they wish to settle the PPL. The following alternatives are available:
  - (i) sell all or some of the Securities. The sale proceeds will be used to repay all or some of the PPL and any surplus will be forwarded to the Investor. This will involve the Investor exercising the Put Option if any of the Securities are below the Protected Price;
  - (ii) use their own funds to repay the PPL and keep the relevant Securities;
  - (iii) extend the Term of a PPL by applying for a new loan (subject to availability and credit approval); or
  - (iv) a combination of the above.

The above alternatives are also available for Investors who utilised the Reduced Interest Rate feature whereby the Call Option is not exercised;

- (n) any ordinary Dividends paid in respect of the Securities purchased under the PPL are paid to the Investors;
- (o) Securities acquired as a result of participating in a Dividend Reinvestment Plan will be retained by the Investors at the Final Maturity Date of the PPL; and
- (p) Investors would be required to pay any brokerage, taxes, costs, charges and commission (if any) in relation to the purchase and sale of Securities, and the preparation of PPL documentation, including any stamp duty and brokerage fees.

## **The participants**

16. The Bank is the provider of the PPL to Investors to fund the acquisition of Securities under the PPL.

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

## Ruling

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18. Subject to paragraphs 2, 3, 4 and 19 of this Ruling:
- (a) the PPL 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 PPL as follows:
    - (i) 60% (for PPL with a term of one year);
    - (ii) 72.5% (for PPL with a term of two years);
    - (iii) 80% (for PPL with a term of three years);
    - (iv) 82.5% (for PPL with a term of four years); or
    - (v) 85% (for PPL with a term of five years);where the interest rate charged on a PPL 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) section 51AAA of the ITAA 1936 will not apply to deny the deductibility of the interest charge under the PPL allowable under section 8-1 of the ITAA 1997;
  - (d) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest charge under the PPL allowable under section 8-1 of the ITAA 1997;
  - (e) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the interest charge under the PPL allowable under section 8-1 of the ITAA 1997;
  - (f) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of the interest charge under the PPL 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;
- (g) section 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for the interest charge under the PPL 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;
- (h) if the Investor exercises the Put Option at the end of the PPL term, the cost of acquiring the Put Option will be added to the cost base of the Securities under section 134-1 of the ITAA 1997. Any gain or loss on exercise of the Put Option will be disregarded;
- (i) if the Investor does not exercise the Put Option at the end of the PPL term, CGT event C2 will happen pursuant to section 104-25 of the ITAA 1997 and the Investor will make a capital loss equal to the reduced cost base of the Put Option;
- (j) the grant of the Call Option by the Investor to the Bank under the Reduced Interest Rate feature is a CGT event which does not result in a capital gain or a capital loss;
- (k) if the Bank exercises the Call Option granted under the Reduced Interest Rate feature and the Investor transfers Securities to it, CGT event A1 will happen pursuant to section 104-10 of the ITAA 1997 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 Securities. The proceeds received by the Investor from the Bank will be the Call Option Price;
- (l) if the Investor repays the PPL and sells Securities to fund the repayment, the Investor will make a capital gain on selling the Securities equal to the sale proceeds less the cost base of the Securities;
- (m) if, at the Final Maturity Date, the Investor repays the PPL but retains the ownership of the Securities, the payment to the Bank of the difference between the Market Value of the Securities and the Call Option Price will form part of the cost base of the Securities; and
- (n) 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 PPL used to fund the purchase of Securities.

## Assumptions

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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 Securities, carrying on a business of investing in the Securities, or holding the Securities as trading stock or as revenue assets;
- (c) in respect of any interest charges to be paid in advance under the PPL, 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 Securities includes units in a trust, the trust satisfies the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- (e) the dominant purpose of an Investor in entering the arrangement is to derive assessable income from their Securities acquired under the PPL, 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 PPL will be at arm's length.

## Explanation

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### 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 PPL 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 PPL 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 Securities acquired under the PPL falls below their original purchase price. In effect, the Put Option ensures that the Bank will acquire the Securities in full satisfaction of the loan if the 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 PPL 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 PPL.

### **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 PPL 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 PPL.

***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 PPL, 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 PPL from the operation of section 82KZMF, as:

- the prepaid interest expenditure under the PPL is incurred in respect of money borrowed to acquire 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 PPL are at arm's length.

Deductibility of the prepaid interest must therefore be considered under the prepayment rules contained 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 PPL 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 PPL.

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

35. Section 82KZMD sets the amount and timing of deductions for expenditure for an Investor (other than an STS taxpayer for the year of income) that is not an individual and does not incur the expenditure in carrying on a business.

36. Section 82KZMA requires that 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 PPL 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) 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 PPL as described in this Ruling.

39. If the Investor exercises the Put Option at the end of the PPL term by transferring title to the Securities to the Bank in satisfaction of the PPL, 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 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 end of the PPL term, 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).

**Reduced Interest Rate – Call Option**

41. Under the arrangement the Investor grants the Bank a Call Option which may be exercised when the PPL matures if the market price of the Securities is greater than the Capped Price. If the Call Option is exercised, the Investor is required to transfer the Securities to the Bank in consideration for the Call Option Price.

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 Securities to the Bank; or
- (b) cash settle the Call Option obligations.

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

45. The capital proceeds the Investor receives when they deliver their Securities will be the Call Option Price.

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

- (a) selling the Securities themselves and using these funds to pay to the Bank the PPL and the difference

between the Market Value of the Securities and the Call Option Price;

- (b) not selling the Securities but using their own funds to pay to the Bank the PPL and the difference between the Market Value of the Securities and the Call Option Price; or
- (c) borrowing further funds from the Bank or refinances to pay to the Bank the PPL and the difference between the Market Value of the Securities and the Call Option Price.

47. Any sale of the Securities by the Investor will be the disposal of a CGT asset. The Investor will make a capital gain if the proceeds from the disposal are more than the cost base of the Securities. They will make a capital loss if those proceeds are less than the reduced cost base of the Securities.

48. The Investor will be required to pay to the Bank the difference between the Market Value of the Securities and the Call Option Price. This payment is capital expenditure made to preserve the Investor's title to the Securities and it will form part of the Securities' cost base (subsection 110-25(6) of the ITAA 1997).

#### **Part IVA of the ITAA 1936**

49. 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**

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

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**Commissioner of Taxation**

25 May 2005

*Previous draft:*

Not previously issued as a draft

*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
- STS taxpayer
- tax avoidance
- taxation administration

*Legislative references:*

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- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZL(2)(a)
- ITAA 1936 82KZM
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- ITAA 1936 82KZMD
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- ITAA 1936 82KZME(5)
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