



PR 2006/26 - Income tax: deductibility of interest incurred on borrowings related to the Merrill Lynch Structured Equity Loan

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 This document has changed over time. This is a consolidated version of the ruling which was published on *29 March 2006*



Product Ruling

Income tax: deductibility of interest incurred on borrowings related to the Merrill Lynch Structured Equity Loan

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ⓘ This Ruling provides you with the following level of protection:
This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.
A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes. If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

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 scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document.

If the scheme 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 scheme 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 scheme has been implemented as described below and to ensure that the participants in the scheme 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 entity(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 Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant taxation provision(s) identified below apply to the defined class of entities, who take part in the scheme to which this Ruling relates. In this Ruling the scheme is the grant of a put option and the borrowing of money from Merrill Lynch (Australia) Futures Limited (MLAF) under the terms of the 'Merrill Lynch Structured Equity Loan' (the MLSEL). The borrowings are used to fund the acquisition of shares listed on the Australian Stock Exchange (ASX).

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

- the Call Option feature;
- the Dividend Advance feature;
- the security deposit feature; and
- terms that are not for fixed periods of 1, 2, 3, 4 or 5 years,

which are available under the terms of the MLSEL and described in the draft Master Options Finance and Custody Agreement dated 14 March 2006 and the draft Responsible Manager Agency Agreement dated 6 October 2005.

Relevant taxation provision(s)

3. The tax provisions 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;
- section 110-25 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 entities

4. The class of entities to which this Ruling applies is those who enter into the scheme described below on or after the date that this Ruling is made. They will have a purpose of staying in the scheme until it is completed and of deriving assessable income from their involvement as set out in the description of the scheme. In this Ruling these persons are referred to as 'Investors'.

Qualifications

5. The class of entities defined in this Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 10 to 15.

6. If the scheme actually carried out is materially different from the scheme that is described in this Ruling, then:

- this Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Ruling may be withdrawn or modified.

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Date of effect

8. This Ruling applies prospectively from 29 March 2006. However, this 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). Furthermore, the Ruling only applies to the extent that:

- it is not later withdrawn by the *Gazette*; or
- the relevant tax laws are not amended.

Withdrawal

9. This Product Ruling is withdrawn and ceases to have effect after 30 June 2009. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the scheme during the term of the Ruling.

Scheme

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

- application for Product Ruling dated 20 December 2005 received from KPMG Tax Lawyers Pty Limited on behalf of MLAF;
- draft Master Options Finance and Custody Agreement dated 14 March 2006;
- draft Responsible Manager Agency Agreement dated 6 October 2005;
- Structured Equity Loan Summary received 21 October 2005; and
- draft Term Sheet as at 30 June 2005.

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

- (a) the MLSEL will be offered to Investors who are Wholesale Clients under the *Corporations Act 2001*;
- (b) the MLSEL involves the grant of a put option and the making of a full recourse loan by MLAF (the Loan) to an Investor for a fixed term of one, two, three, four, or five years. The term will commence on the trade date agreed between MLAF and the Investor (Trade Date);
- (c) the minimum Loan amount is \$1,000,000;
- (d) the Loan is used by the Investor to finance 100% of the purchase price of shares listed on the ASX which have been approved by MLAF (Underlying Securities);
- (e) the principal amount of the Loan is drawn down on the settlement date of the purchase of the Underlying Securities by a direct payment on the Investor's behalf;
- (f) the Loan is secured by a mortgage, in favour of MLAF, over the Underlying Securities;

- (g) interest payments under the MLSEL are payable by an Investor 12 monthly in advance. The first payment of interest must be paid by the Investor, in full, on the day before the Trade Date and thereafter, on each anniversary of the Trade Date, at a rate determined by MLAF based on prevailing term swap rates plus a margin;
- (h) MLAF will grant the Investor an option to sell the Underlying Securities to MLAF for the amount of the Loan (Put Option);
- (i) an annual premium in respect of the Put Option (Put Option Premium) will be payable by the Investor in advance. The Put Option Premium must be paid by the Investor, in full, on the day before the Trade Date and thereafter, on each anniversary of the Trade Date;
- (j) at the end of the term (the Principal Advance Repayment Date) the following may occur:
 - (i) the Put Option is exercised
MLAF will acquire the Underlying Securities from the Investor for an amount equal to the Loan. The proceeds will be applied to repay the Loan. The Put Option will be automatically exercised on the Principal Advance Repayment Date where the market value of the Underlying Security is less than the Loan amount; or
 - (ii) the Loan is repaid by the Investor from their own funds
The mortgage will be discharged and the Underlying Securities will be transferred to the Investor; or
 - (iii) MLAF will sell the Underlying Securities
The proceeds from the sale will be applied to repay the Loan. Any surplus funds will be distributed to the Investor; and
- (k) Investors are entitled to all dividends received from the Underlying Securities during the term of the MLSEL.

The Participants

12. MLAF provides the Loans to Investors to fund the purchase of the Underlying Securities and grants the Put Options to Investors.

13. The purchase and sale of the Underlying Securities will be conducted by Merrill Lynch Equities (Australia) Limited in its capacity as broker and ASX member.

14. Custodial and nominee services, will be conducted by Berndale Securities Limited in its capacity as settlement and clearing agent and nominee.

15. As mentioned above, the MLSEL will only be offered to those Investors who are Wholesale Clients under the *Corporations Act 2001*.

Ruling

16. Subject to paragraphs 2 and 17 of this Ruling:

- (a) The MLSEL interest charge allowable as a deduction under section 8-1 of the ITAA 1997, in a particular income year, is the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or the relevant percentage of the sum of the interest charge and the Put Option Premium (Total Cost) charged by MLAF under the MLSEL as follows:
- (i) 60% (for MLSEL with a term of one year);
 - (ii) 72.5% (for MLSEL with a term of two years);
 - (iii) 80% (for MLSEL with a term of three years);
 - (iv) 82.5% (for MLSEL with a term of four years); or
 - (v) 85% (for MLSEL with a term of five years).

Where the interest rate charged on a MLSEL 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 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 Cost charged by MLAF and the amount allowable as a deduction under paragraph 16(a) is not allowable as a deduction under section 8-1 of the ITAA 1997 (Capital Protection Cost);
- (c) section 51AAA of the ITAA 1936 will not apply to deny deductibility of the interest charge 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 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 the deductions for the interest charge 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 allowable under section 8-1 of the ITAA 1997, where at least one of the following applies for the year of income:
 - (i) the Investor is a Simplified Tax System (STS) taxpayer; or
 - (ii) the Investor is an individual who does not incur the interest charge in carrying on a business;
- (g) section 82KZMD of the ITAA 1936 will apply to set the amount and timing of the deductions for the interest charge that is deductible under section 8-1 of the ITAA 1997 to an Investor (other than STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not carry on a business;
- (h) the Capital Protection Cost will be included in the first element of the cost base and the reduced cost base of the Put Option under subsections 110-25(2) and 110-55(2) of the ITAA 1997;
- (i) if the Put Option is exercised, the Capital Protection Cost will be included in the second element of the cost base and reduced cost base of the Underlying Securities under subsection 134-1(1) of the ITAA 1997. Any gain or loss on exercise of the Put Option will be disregarded by virtue of subsection 134-1(4) of the ITAA 1997;
- (j) if the Put Option is not exercised and it expires, under paragraph 104-25(1)(c) of the ITAA 1997 Capital Gains Tax (CGT) event C2 will happen. The Investor will make a capital loss equal to the reduced cost base of the Put Option under subsection 104-25(3); and
- (k) the anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny the deductibility of the interest charge allowable under section 8-1 of the ITAA 1997 in respect of borrowings by the Investor under the MLSEL.

Assumptions

17. This Ruling is made on 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 listed shares, carrying on a business of investing in listed shares, or holding their interests in listed shares as trading stock or as a revenue asset;
 - (c) in respect of any interest charge to be paid in advance under the MLSEL, 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) the dominant purpose of an Investor entering the arrangement is to derive assessable income from their investment in the Underlying Securities comprising dividends or capital gains;
 - (e) the scheme will be executed in the manner described under the 'Scheme' section of this Ruling; and
 - (f) all dealings by the Investors and MLAF under the MLSEL will be at arm's length.

Commissioner of Taxation

29 March 2006

Appendix 1 – Explanation

❶ *This Appendix is provided as information to help you understand how the Commissioner’s view has been reached. It does not form part of the binding public ruling.*

Section 8-1

18. Interest paid on 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 of the ITAA 1997 where it is expected that assessable income will be derived from the investment (see Taxation Ruling TR 95/33).

19. Investors should only claim deductions in a particular year of income, for that part of the Total Cost (the sum of the interest charge and the Put Option Premium) that does not exceed the amount described in paragraph 16(a).

20. The Capital Protection Cost (the difference between the Total Cost and the amount allowable as a deduction under section 8-1 of the ITAA 1997) is allocated to the cost of the Put Option. The Put Option ensures that the Investor is protected from liability to repay the Loan if the value of the Underlying Securities falls below the Loan amount. The Capital Protection Cost is not deductible under section 8-1.

Section 51AAA

21. Under the arrangement, it is contemplated that an Investor will derive assessable income by way of dividends paid on the Underlying Securities and capital gains. As the interest allowable under section 8-1 of the ITAA 1997 would have been deductible notwithstanding the inclusion of a net capital gain in assessable income, section 51AAA of the ITAA 1936 has no application to an Investor in the MLSEL.

Section 82KL

22. The operation of section 82KL of the ITAA 1936 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

23. Subdivision H of Division 3 of Part III of the ITAA 1936 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 of expenditure that are of a capital nature.

Subdivisions 328-F and 328-G – STS taxpayers

24. 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.

25. 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 businesses 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

26. The interest charge allowable under section 8-1 of the ITAA 1997 are 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 of Division 3 of Part III of the ITAA 1936, 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, which is 12 months, and not to the period of the Loan.

Sections 82KZME and 82KZMF: prepaid expenditure and 'tax shelter' arrangements

27. The rules in sections 82KZME and 82KZMF of the ITAA 1936 apply, subject to the exceptions in section 82KZME, where expenditure is incurred in relation to a 'tax shelter' arrangement for the doing of a thing that is not to be wholly done within the expenditure year.

28. For the purposes of section 82KZME of the ITAA 1936, '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 MLSEL, including the financing, share acquisition and share disposal arrangements.

29. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the interest charge allowable under section 8-1 of the ITAA 1997 incurred on borrowings under the MLSEL from the operation of section 82KZMF of the ITAA 1936 as:

- the prepaid interest expenditure allowable under section 8-1 of the ITAA 1997 for the MLSEL is incurred in respect of money borrowed to acquire shares that are listed for quotation on the ASX;
- the Investor can reasonably expect to obtain dividend 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 MLSEL scheme are at arm's length.

Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 30 to 35.

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

30. Section 82KZM of the ITAA 1936 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
- a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

31. The expenditure must not be excluded expenditure and must be incurred otherwise than in carrying on a business. Section 82KZM of the ITAA 1936 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.

32. As the eligible service period in relation to a deductible interest prepayment under the MLSEL is not longer 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 of the ITAA 1936 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 charge allowable under section 8-1 of the ITAA 1997 incurred under the MLSEL.

Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by non-individuals and non-STs taxpayers

33. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for a taxpayer (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.

34. 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.

35. For these Investors, the deduction for prepaid interest allowable under section 8-1 of the ITAA 1997 under the MLSEL will be apportioned over the relevant interest payment period.

Section 110-25 and Division 134: cost base of the Put Option

36. The Capital Protection Cost (see paragraph 16(b)) is included in the first element of the cost base and reduced cost base of the Put Option pursuant to subsections 110-25(2) and 110-55(2) of the ITAA 1997.

37. If the Put Option is not exercised, the Investor will make a capital loss, at the time the Put Option expires, equal to the reduced cost base of the Put Option (CGT event C2, paragraph 104-25(1)(c) of the ITAA 1997).

38. If the Put Option is exercised and title to the Underlying Securities is transferred to MLAF, any gain or loss on exercise of the Put Option is disregarded by virtue of subsection 134-1(4) of the ITAA 1997. The Investor will include the Capital Protection Cost in the cost base and reduced cost base of the Underlying Securities (item 2 of the table in subsection 134-1(1)).

Part IVA

39. Provided that the arrangement ruled on is entered into and carried out as described (see the Arrangement section of this Ruling), it is accepted that the arrangement is an ordinary commercial transaction and that Part IVA of the ITAA 1936 will not apply.

Appendix 2 – Detailed contents list

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References

- Previous draft:*
- Not previously issued as a draft
- Related Rulings/Determinations:*
- TR 92/20; TR 95/33
- Subject references:*
- debt deductions
 - financial products
 - interest expense
 - prepaid expense
 - product rulings
 - public rulings
 - tax administration
 - tax avoidance
- Legislative references:*
- TAA 1953
 - 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 82KZMF
 - ITAA 1936 Pt IVA
 - ITAA 1997 8-1
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 - ITAA 1997 104-25(3)
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NO: 2005/15944
ISSN: 1441-1172
ATOlaw topic: Income Tax ~~~ Product ~~~ finance