PR 2007/28 - Income tax: PCM Shared Equity Contract

Product Ruling

Income tax: PCM Shared Equity Contract

Contents Para

This publication 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 entities must form their own view about the commercial and financial viability of the product. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential entities by confirming that the tax outcomes 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, entities lose the protection of this Product Ruling.

Terms of use of this Product Ruling

This Product Ruling has been given on the basis that the entity(s) who applied for the Product 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 Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling part apply to the defined class of entities, who take part in the scheme to which this Ruling relates. The scheme in this Product Ruling involves a form of financing in which a Home Owner and PCM Enhanced Residential Property Fund (the Property Fund) enter into an agreement called a Shared Equity Contract (SEC) to share the equity interest in a dwelling that is the Home Owner's principal place of residence. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

Class of entities

2. This part of the Product Ruling specifies which entities can rely on the tax outcomes set out in the Ruling section of this Product Ruling and which entities cannot rely on those tax outcomes.

3. The class of entities to which this Ruling applies consists of entities who are individuals that enter into the scheme specified below on or after the date this Product Ruling is made and who have executed an SEC with PCM Capital Management Australia Pty Ltd (PCM) as agent or nominee for the Property Fund on or before 30 June 2007. In this Ruling these entities are referred to as Home Owners.

4. The class of entities who can rely on the tax outcomes set out in the Ruling section of this Product Ruling does **not** include entities:

- who are not Australian residents for taxation purposes;
- who enter into an SEC with the Property Fund but are not registered on the title of the property;
- who enter into an SEC with the Property Fund that differs materially from the SEC provided to the Tax Office with the application for this Product Ruling and described below;
- whose dwelling is not, or has not been their main residence throughout the ownership period, and during the term of the SEC, or where section 118-190 has application; or
- who are accepted to participate in a SEC prior to the issue of this Ruling or after 30 June 2007.

Qualifications

5. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 19 to 41 of this Ruling.

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

- this Product 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 Product Ruling may be withdrawn or modified.

Date of effect

8. This Product Ruling applies prospectively from 4 April 2007, the date this Product Ruling is made. It therefore applies only to the specified class of entities that enter into the scheme from 4 April 2007 until 30 June 2007, being the closing date for entry into the scheme. This Product Ruling provides advice on the availability of tax outcomes to the specified class of entities for the income years up to 30 June 2007. This Product Ruling will continue to apply to those entities even after its period of application for schemes entered into during the period of application.

9. However the Product Ruling only applies to the extent that:

- there is no change in the scheme or in the entity's involvement in the scheme;
- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

10. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

11. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

12. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Changes in the law

13. Although this Product Ruling deals with the laws enacted at the time it was issued, later amendments may impact on this Product Ruling. Any such changes will take precedence over the application of the Ruling and, to that extent this Product Ruling will have no effect.

14. Entities who are considering participating in the scheme are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

15. Product Rulings were introduced for the purpose of providing certainty about tax outcomes for entities in schemes such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling is issued.

Ruling

Application of this Ruling

16. Subject to the stated qualifications, this part of the Product Ruling sets out the taxation outcomes for a Home Owner in the defined class of entities who enters into the scheme described at paragraphs 19 to 41 of this Ruling. The Ruling will apply to a Home Owner who enters into a SEC with the Property Fund either:

- to acquire a Property as their principal place of residence; or
- to sell an interest in an existing Property that is their principal place of residence.

Amount received by a Home Owner entering into a SEC

17. The payment by the Property Fund to the Home Owner or to a person from whom a Home Owner purchases the Property in return for an interest in the Property under an SEC will not result in any amount being included in the Home Owner's assessable income as ordinary income under section 6-5, or as statutory income under section 6-10, including an amount calculated under the Capital Gains and Losses provisions in Part 3-1.

18. This Product Ruling has no relevance to, nor has it considered the nature of return to the Property Fund under the SEC.

Scheme

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

- Application for a Product Ruling received 3 March 2006 which includes additional documents and information provided on 10 and 27 March 2006, 22 September 2006, and 28 November 2006, 26 February 2007 and 26 March 2007, made on behalf of ING Real Estate Managed Investments Limited (ING) as Responsible Entity of the PCM Enhanced Residential Property Fund and PCM Capital Management Australia Pty Ltd (PCM) (as nominee or agent for ING);
- Executed PCM Enhanced Residential Property Fund Constitution, dated 19 February 2007, received 26 February 2007; and
- the **PCM Shared Equity Contract,** dated February 2006, received 3 March 2006.

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

20. The documents highlighted are those that a Home Owner may enter into. For the purposes of describing the scheme to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Home Owner, or any associate of a Home Owner, will be a party to, which are a part of the scheme. The effect of these agreements is summarised as follows.

21. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

The Shared Equity Contract

22. The SEC is a form of home financing in which, for a defined period of either 5 years or 10 years, the Home Owner and the Property Fund will share the interest in a dwelling that is the Home Owner's principal place of residence (the Property). 'Dwelling' has the meaning shown in section 118-115 and 'principal place of residence' has the same meaning as 'main residence' in Subdivision 118-B.

23. During this defined period the Home Owner will retain full legal title to the Property and have the exclusive right to reside in it. Under the SEC the Property Fund will have a registrable interest in the Property, which will be supported by a caveat and a registered mortgage over the Property.

24. The SEC sets out the contractual relationship between a Home Owner and the Property Fund, including the nature of the interest acquired by the Property Fund, and the circumstances in which the Home Owner may acquire the Property Fund's interest in the Property.

25. The Property Fund will appoint PCM as agent or nominee to enter into an SEC with a Home Owner who currently owns a Property or, alternatively, where the Home Owner wishes to purchase a Property.

26. The Property Fund acquires a percentage interest in the Home Owner's Property, as specified in the Contract Application. The Property Fund and the Home Owner will hold their respective interests as tenants in common during the Term of the SEC (section 1, clause 2).

27. A Home Owner may choose to enter into an SEC for a term of either 5 years or a term of 10 years, but there is provision under the SEC for the term to be extended for a further five years.

28. In return for the Property Fund paying to the Home Owner or the person from whom the Home Owner purchases the Property, an amount of money, the Property Fund will acquire an interest in the Property called the Initial Equity Interest. The Initial Equity Interest is the proportion of the purchase made by the Property Fund expressed as a percentage of the value of the Property as at the date of the investment. The value of the Property will be determined by a Property Fund approved valuer or in case of a purchase of a Property, by reference to a third party sale contract.

29. The minimum amount the Property Fund will provide to a Home Owner is $50,000 and the maximum amount will be 25% of the initial property valuation for an SEC with 10 year term and 30% for an SEC with a five year term.

30. Notwithstanding the Property Fund's interest in the Property, it holds no right to occupy the Property as a result of acquiring the interest (section 1, clause 3).

31. Among other things, a Home Owner entering into an SEC warrants that:

- the Property is and will remain the Home Owner's principal place of residence (section 1, clause 4(ii));
- the property is not used commercially (section 1, clause 4(iii));
- it will disclose all appraisals and valuations of the Property undertaken in the 2 years immediately prior to entering into the SEC (section 1, clause 4(iv));
- all information provided to the Property Fund by the Home Owner is full and correct and not misleading, including all information in the Contract Application (section 1, clause 4(vii)); and
- the Property is and will continue to be maintained in good order and condition (section 1, clause 4(x)).

32. Each year the Home Owner is required to provide evidence that the Property remains the Home Owner's principal place of residence. If the Home Owner does not provide evidence that it remains their principal place of residence, the Property Fund may require the Home Owner to remedy that situation and, in default of any remedy, in its discretion it may:

- require the Home Owner to repay the Property Fund's interest in the Property (section 1, clause 6(i)); or
- increase the Equity Appreciation Rate (see paragraph 35 of this Ruling) by 2% per annum for the period where the Property is not the Home Owner's principal place of residence and until such time as the Property again becomes the principal place of residence of the Home Owner (section 1, clause 6(ii)).

33. During the term of the SEC the Home Owner is required to maintain comprehensive general insurance over the Property in respect of fire, flood, earthquake and other catastrophic risks, public liability risk and any other risk that the Property Fund shall reasonably require. The Home Owner will provide the Property Fund with a copy of the insurance policy which must name the Property Fund as a beneficiary of the policy (section 8, clause 1).

34. The insurance policy must provide full coverage of the present value of the Property, including the full insurable value of the Property Fund's interest (section 8, clause 2).

35. The Home Owner agrees that during the term of the SEC they cannot rent out the Property and agrees that the creation of any third party right of possession or occupation of the Property will breach the Home Owner's obligations to reside in the Property as their principal place of residence (section 12, clause 3).

36. **This Product Ruling will not apply to a Home Owner where the Property is not the principal place of residence of the Home Owner throughout the 'ownership period' and during the term of the SEC.** For the purposes of this Product Ruling 'ownership period' has the meaning shown in section 118-125.

37. During the term of the SEC no interest is payable to PCM by the Home Owner. Instead, the return to the Property Fund is based on the Initial Equity Interest (the amount originally paid to the Home Owner) increased by the Equity Appreciation Rate (4% per annum compounding monthly in arrears). The resultant percentage (which can never exceed 40%) is applied to the market value of the Property at the expiry of its term or at any earlier repayment dates, if the Home Owner chooses to make such repayments.

38. During the term of the SEC a Home Owner may choose to make payments to repurchase some or all of the Property Fund's interest in the Property. A Home Owner may repurchase up to 100% of the Property Fund's interest in the Property prior to expiry of the SEC. However, there are certain restrictions and conditions which apply and fees and charges which may be levied (section 6).

39. The Home Owner also retains the right to sell the Property to a third party at any time during the term of the SEC without penalty, provided that the sale is at arm's length (section 12, clause 1). If the Property is sold during the term of the SEC the Home Owner is required to repurchase the interest of the Property Fund in the Property based on its equity interest in the Property, determined under the SEC, at that time.

40. Otherwise, at the end of the term of the SEC it is intended that the Home Owner will be required to repurchase all of the interest in the Property held by the Property Fund. The repayment may be made from the Home Owner's own funds or by selling the Property to a third party in an arm's length sale.

41. Among other things, the SEC also sets out in detail the following matters:

- procedures in determining base and maturity value of the Property (section 3);
- procedures on valuation (section 4);
- procedures for PCM to require the Home Owner to repay PCM's equity interest in the Property (section 5);
- the obligation that the Home Owner maintain the Property (section 7);
- the Home Owner's obligation to pay taxes, duties, rates, levies, and other Property expenses (section 9);
- the requirement for the Home Owner to comply with governmental orders and approvals (section 10);

- changes and improvements to the Property (section 11);
- refinancing and other securities (section 13);
- events and procedures in respect to defaulting Home Owners (section 15);
- the Property Fund's exercise of rights (section 16);
- the Property Fund's power of sale after the expiration date (section 17); and
- the Property Fund's power of attorney (section 21).

Commissioner of Taxation
4 April 2007

Appendix 1 – Explanation

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.

Ordinary income under section 6-5

42. For the amount received by a Home Owner who enters into a SEC to be included in the Home Owner's assessable income under section 6-5 it must be 'ordinary income'. 'Ordinary income' is defined under section 6-5 to be 'income according to ordinary concepts'. Although the courts and the legislature have consistently declined to define the limits of what will fall within the concept of 'income' the decision of Jordan CJ in *Scott v. Commissioner of Taxation* (1935) 52 WN (NSW) 44; (1935) 3 ATD 142 at 144; (1935) SR (NSW) 215 at 219 is a useful reference:

> The word 'income' is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind…

43. Among the features that the courts have considered important in determining whether an amount is ordinary income as distinct from capital are the flow concept (as articulated by Pitney J in *Eisner v. Macomber* (1920) 252 US 189 at 206) and whether the amount is recurrent and regular (see for example the decision in *Federal Commissioner of Taxation v. Dixon* (1952) 86 CLR 540; (1952) 26 ALJ 505; [1953] ALR 17; (1952) 10 ATD 82). In certain circumstances, an isolated transaction may also fall within scope of 'income according to ordinary concepts' (see the decision of the High Court in *Commissioner of Taxation v. The Myer Emporium Ltd* (1987) 163 CLR 199; (1987) 61 ALJR 270; (1987) 71 ALR 28; (1987) 87 ATC 4363; (1987) 18 ATR 693 (*Myer*)).

44. The money received by a Home Owner entering into an SEC with the Property Fund is a once only receipt. It is not received regularly and recurrently over the term of the SEC and is outside the expanded notion of income according to ordinary concepts that results from the decision in *Myer*. Further, it does not flow from the provision of the Property to the Property Fund being instead a disposition of an interest in that Property to the Property Fund for the term of the SEC. Accordingly, the money received by a Home Owner from the Property Fund is not included in assessable income under section 6-5.

Statutory income under section 6-10

45. Amounts that are not ordinary income may, however, be included in assessable income under section 6-10 if they are statutory income. Section 10-5 contains a comprehensive list of the provisions under which statutory income may accrue to a taxpayer. Of particular relevance to the amount received by a Home Owner entering into a SEC are net capital gains included in assessable income of a taxpayer under section 102-5.

Capital gains and losses under Part 3-1

46. In general terms, a capital gain will be included in the assessable income of a taxpayer where a 'CGT asset' is subject to a 'CGT event': Division 102. The term 'CGT asset' is defined in subsection 108-5(1) and the 'CGT' events are listed in Division 104 of Part 3-1.

47. When a Home Owner enters into an SEC with the Property Fund in exchange for a disposition of an interest in the Property for the Term of the SEC, there is a 'CGT event' in respect of a 'CGT asset', being the Property. During the Term of the SEC the Home Owner retains the legal ownership of the Property but disposes of an equitable interest in the ownership to the Property Fund.

48. The disposal of the interest by the Home Owner to the Property Fund will fall under CGT event A1 in section 104-10. The Home Owner will make a capital gain if the 'capital proceeds' from the disposal are more than the asset's 'cost base' and will make a capital loss if those 'capital proceeds' are less than the asset's 'reduced cost base': subsection 104-10(4).

49. However, any capital gain or capital loss made by the Home Owner is disregarded if a CGT event happens in relation to a CGT asset that is a dwelling or an ownership interest in the dwelling where the Home Owner is an individual and the dwelling is their main residence throughout the ownership period: section 118-110.

50. As the taxation outcomes set out in this Product Ruling are confined to Home Owners who are individuals whose Property has been and will remain their main residence throughout the ownership period and during the term of the SEC, Division 118 generally, and section 118-110 specifically, will apply to any capital gain or capital loss made by a Home Owner.

Application of section 6-10 generally

51. Entering into the SEC does not result in an amount being included in the assessable income of a Home Owner as statutory income under section 102-5 or under any other provision listed in section 6-10.

Appendix 2 – Detailed contents list

52. The following is a detailed contents list for this Ruling:

References

Previous draft:

Not previously issued as a draft

Subject references:

- capital gains
- main residence
- product rulings
- public rulings
- ordinary income
- statutory income
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project
- taxation administration

Legislative references:

- ITAA 1997 6-5
- ITAA 1997 6-10
- ITAA 1997 10-5
- ITAA 1997 Pt 3-1
- ITAA 1997 Div 102
- ITAA 1997 102-5
- ITAA 1997 Pt 3-1
- ITAA 1997 Div 104
- ITAA 1997 104-10
- ITAA 1997 104-10(4)
- ITAA 1997 108-5(1)
- ITAA 1997 Div 118
- ITAA 1997 Subdiv 118-B
- ITAA 1997 118-110
- ITAA 1997 118-115
- ITAA 1997 118-125
- ITAA 1997 118-190
- TAA 1953
- TAA 1953 Sch 1 357-75(1)
- Copyright Act 1968

Case references:

- Commissioner of Taxation v. The Myer Emporium Ltd (1987) 163 CLR 199; (1987) 61 ALJR 270; (1987) 71 ALR 28; (1987) 87 ATC 4363; (1987) 18 ATR 693
- Eisner v. Macomber (1920) 252 US 189
- Federal Commissioner of Taxation v. Dixon (1952) 86 CLR 540; (1952) 26 ALJ 505; [1953] ALR 17; (1952) 10 ATD 82
- Scott v. Commissioner of Taxation (1935) 52 WN NSW 44; (1935) 3 ATD 142; (1935) SR (NSW) 215

ATO references

NO: 2006/24830
ISSN: 1441-1172
ATOlaw topic: Income Tax ~~ Product ~~ finance