PR 2008/55 - Income tax: deductibility of interest incurred on borrowings related to the Merrill Lynch Structured Equity Loan

Product Ruling

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

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.

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

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. 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.

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 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 participate in the scheme to which this Ruling relates.

2. In this Ruling the scheme is the investment in shares listed on the Australian Securities Exchange (ASX) using a full recourse loan (the Loan) made by Merrill Lynch (Australia) Futures Limited (MLAF) under the terms of the 'Merrill Lynch Structured Equity Loan' (MLSEL).

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

- the Call Option feature;
- the Dividend Advance feature;
- the Stock Lending feature; and
- the Security Deposit feature,

which are available under the terms of the MLSEL and described in the Master Options Finance and Custody Agreement dated 2 August 2007 and the Responsible Manager Agency Agreement dated 14 April 2008.

Class of entities

4. The class of entities who can rely on this Product Ruling consists of those entities that are accepted to participate in the scheme specified below on or after the date this Product Ruling is published and which execute agreements mentioned in paragraph 18 of this Ruling on or before 30 June 2011. At the time of entering the scheme, they must have a purpose of staying in the scheme until it is completed (that is being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement. These entities are referred to as Investors.

Superannuation Industry (Supervision) Act 1993

5. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA 1993). The Tax Office gives no assurance that the product is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product ruling as to whether investment in this product may contravene the provisions of SISA 1993.

Qualifications

6. The class of entities defined in this Ruling may rely on it provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 18 to 22 of this Ruling.

7. 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

9. This Product Ruling applies prospectively from 4 June 2008, the date this Ruling is published. It therefore applies to the specified class of entities that enter into the scheme from 4 June 2008 until 30 June 2011, being its period of application. 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.

10. 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.

11. 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)).

12. 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.

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.

15. [Omitted.]

Note to promoters and advisers

16. Product Rulings were introduced for the purpose of providing certainty about tax consequences 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

17. Subject to paragraphs 3 and 22 of this Ruling:

(a) an amount equal to the interest incurred on the Loan in an income year, reduced by an amount reasonably attributable to the cost of capital protection worked out under step 3 of the method statement in subsection 247-20(3) of the *Income Tax Assessment Act 1997* (ITAA 1997) will be deductible under section 8-1 of the ITAA 1997;

(b) under subsection 247-20(3) of the ITAA 1997, the amount reasonably attributable to the cost of capital protection in an income year is the amount by which the interest incurred on the Loan in the income year exceeds an amount representing the interest that would have been incurred for the income year on the Loan if the following interest rates applied:

- where the interest rate incurred on the Loan is at a fixed rate for all or part of the term of the Loan and that fixed rate is applicable to the Loan for all or part of the income year, the relevant rate is the sum of the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Housing Loans and 100 basis points (the 'adjusted loan rate') at the time the first of the amounts of interest on the Loan is incurred during the term of the Loan, or the relevant part of the term of the Loan (subsections 247-20(4) and (5)); and
- where the interest rate incurred on the Loan is at a variable rate for all or part of the term of the Loan and a variable rate is applicable to the Loan for all or part of the income year, the relevant rate is the average of the adjusted loan rates applicable during those parts of the income year when the Loan is at a variable rate (subsections 247-20(5) and (5A));

(c) the amount reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997 (the Excess Amount), as worked out under paragraph 17(b) of this Ruling, is treated as the cost of the Investor's Put Option under subsection 247-20(6) of the ITAA 1997. The cost of the Investor's Put Option (if any) is not deductible under section 8-1 of the ITAA 1997;

(d) section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny deductibility of the interest allowable under section 8-1 of the ITAA 1997;

(e) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest allowable under section 8-1 of the ITAA 1997;

(f) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of the prepaid interest allowable under section 8-1 of the ITAA 1997 in respect of borrowings under a Loan;

(g) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of prepaid interest on a Loan 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 small business entity as defined in subsection 328-110(1) of the ITAA 1997; or

(ii) the Investor is an individual who does not incur that expenditure in carrying on a business;

(h) section 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of the deductions for prepaid interest on borrowings under a Loan that is allowable under section 8-1 of the ITAA 1997 to an Investor (other than a small business entity for the year of income) who is a taxpayer that is not an individual and does not carry on a business;

(i) if the Investor invokes the capital protection under the Loan, the Investor is taken to have exercised the Put Option pursuant to subsection 247-30(1) of the ITAA 1997. The Excess Amount as described in paragraph 17(b) of this Ruling (if any) will form part of the cost base and the reduced cost base of the Underlying Securities under section 134-1 of the ITAA 1997. Any capital gain or capital loss upon the exercise of the Put Option will be disregarded by virtue of subsection 134-1(4);

(j) if the Investor does not invoke the capital protection under the Loan, the Put Option is taken to have expired under subsection 247-30(2) of the ITAA 1997. The Excess Amount as described in paragraph 17(b) of this Ruling (if any) will form part of the cost base (under subsection 110-25(2) of the ITAA 1997) and the reduced cost base (under section 110-55 of the ITAA 1997) of the Put Option;

(k) a CGT event will occur under section 104-25 of the ITAA 1997 if the Put Option is taken to have expired. The Investor will make a capital loss equal to the reduced cost base of the Put Option;

(l) 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.

Scheme

18. The scheme that is the subject of this Product Ruling is described below. The scheme is incorporated within the following documents:

- application for Product Ruling dated 4 December 2007 received from KPMG Tax Lawyers Pty Limited on behalf of MLAF;
- Master Options Finance and Custody Agreement dated 2 August 2007;
- Responsible Manager Agency Agreement dated 14 April 2008;
- updated Term Sheet received 20 March 2008; and
- further information received from KPMG Tax Lawyers Pty Limited on 11 April 2008 and 1 May 2008.

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

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

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

Overview

21. Following is a summary of the scheme:

(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 to an Investor for a term of any period between one and 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 Loan 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). No explicit fee will be paid by the Investor for the Put Option;

(i) 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;

(j) Investors are entitled to all dividends received from the Underlying Securities during the term of the MLSEL.

Assumptions

22. 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 and 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
4 June 2008

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.

Section 8-1 and Division 247

23. 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).

24. Division 247 of the ITAA 1997 applies to the scheme as it is a capital protected borrowing (CPB). The Investor uses the Loan to acquire a beneficial interest in ASX listed shares and the Investor is wholly or partly protected against a fall in the market value of the investment.

25. Division 247 of the ITAA 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a CPB (section 247-20 of the ITAA 1997). Division 247 of the ITAA 1997 ignores any amount which is not in substance for capital protection or interest, in calculating the cost of capital protection (subsection 247-20(3) of the ITAA 1997).

26. Where an Investor enters into the Loan, the amount reasonably attributable to capital protection, is worked out under the method statement in subsection 247-20(3) of the ITAA 1997, as set out in paragraph 17(b) of this Ruling.

27. Under step 1 of the method statement, the total amount incurred by the Investor under or in respect of the CPB for the income year, includes the interest incurred on the Loan for the income year.

28. Where the total amount incurred by the Investor under step 1 of the method statement for the income year is less than the total interest that would have been incurred by the Investor worked out under step 2 of the method statement, there is no amount reasonably attributable to the cost of capital protection. In these circumstances, the interest incurred on the Loan for the income year will be deductible.

29. Where the total amount incurred by the Investor under step 1 of the method statement for the income year is greater than the total interest that would have been incurred by the investor worked out under step 2 of the method statement, the Excess Amount is reasonably attributable to the cost of capital protection and is treated as if it were incurred only for the Put Option. The Put Option is a capital asset for an Investor. Therefore, the amount reasonably attributable to the cost of capital protection is capital in nature and not deductible under section 8-1 of the ITAA 1997.

Section 51AAA

30. Under the scheme, 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

31. 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

32. 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 a 'small business entity', 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.

Subdivision 328-C – small business entities

33. An Investor will be a small business entity for an income year if the Investor carries on a business and either:

- the Investor carried on a business in the previous income year and the Investor's aggregated turnover for the previous year was less than $2 million; or
- the Investor's aggregated turnover in the current income year is likely to be less than $2 million.

The eligible service period for the purposes of Subdivision H of Division 3 of Part III

34. The prepaid interest charges on the Loan 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

35. 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.

36. 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.

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

- the prepaid interest expenditure allowable under section 8-1 of the ITAA 1997 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 38 to 43 of this Ruling.

Section 82KZM: prepaid expenditure incurred by small business entities and individuals incurring non-business expenditure

38. 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 small business entity for the year of income; or
- a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

39. 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.

40. As the eligible service period in relation to a deductible interest prepayment under the Loan 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 small business entities 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 allowable under section 8-1 of the ITAA 1997 incurred under the Loan.

Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by non-individuals and non-small business entities

41. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for a taxpayer (other than a small business entity for the year of income) that is not an individual and does not incur the expenditure in carrying on a business.

42. 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.

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

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

44. If the Investor invokes the capital protection under the Loan, the Investor is taken to have exercised the Put Option pursuant to subsection 247-30(1) of the ITAA 1997. The Excess Amount as described in paragraph 17(b) of this Ruling (if any) will form part of the cost base and the reduced cost base of the Underlying Securities under section 134-1 of the ITAA 1997. Any capital gain or capital loss upon the exercise of the Put Option will be disregarded by virtue of subsection 134-1(4).

45. If the Investor does not invoke the capital protection under the Loan, the Put Option is taken to have expired under subsection 247-30(2) of the ITAA 1997. The Excess Amount as described in paragraph 17(b) of this Ruling (if any) will form part of the cost base (under subsection 110-25(2) of the ITAA 1997) and the reduced cost base (under section 110-55 of the ITAA 1997) of the Put Option. The Investor will make a capital loss at the time the Put Option is taken to expire equal to the reduced cost base of the Put Option (CGT Event C2, paragraph 104-25(1)(c) of the ITAA 1997).

Part IVA

46. Provided that the arrangement ruled on is entered into and carried out as described (see the Scheme 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

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

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 95/33

Previous Rulings/Determinations:

PR 2006/26

Subject references:

- financial products
- interest expense
- prepaid expense

Legislative references:

- ITAA 1936 51AAA
- ITAA 1936 82KL
- 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 III Div 3 Subdiv H
- ITAA 1936 Pt IVA
- ITAA 1997 8-1
- ITAA 1997 104-25
- ITAA 1997 104-25(1)(c)
- ITAA 1997 110-25
- ITAA 1997 110-25(2)
- ITAA 1997 110-55
- ITAA 1997 Div 134
- ITAA 1997 134-1
- ITAA 1997 134-1(4)
- ITAA 1997 Div 247
- ITAA 1997 247-20
- ITAA 1997 247-20(3)
- ITAA 1997 247-20(4)
- ITAA 1997 247-20(5)
- ITAA 1997 247-20(5A)
- ITAA 1997 247-20(6)
- ITAA 1997 247-30(1)
- ITAA 1997 247-30(2)
- ITAA 1997 Subdiv 328-C
- ITAA 1997 328-110(1)
- Corporations Act 2001
- SISA 1993
- TAA 1953
- TAA 1953 Sch 1 357-75(1)

ATO references

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