Taxation Determination

Income tax: section 8-1 of the *Income Tax Assessment Act 1997*: capital protected loan facility with a call option writing feature: interest deductibility

Preamble

The number, subject heading, date of effect and paragraphs 6 to paragraphs 13 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

On 16 April 2003 the Treasurer announced amendments to the Income Tax Assessment Act 1997 to ensure part of the expense of a capital protected product is attributed to the cost of the capital protection feature. The expense is apportioned in accordance with the guidelines (interim methodology) announced by the Minister for Revenue and Assistant Treasurer on 30 May 2003 in the press release 'Taxation of Capital Protected Products'.

This Taxation Determination relates to that part of the interest expense that is available for a deduction in accordance with the interim methodology and is referred to in this Taxation Determination as 'Interest'.

Background

1. A capital protected loan facility is a fixed term loan used to purchase shares or other securities listed on the Australian Stock Exchange (referred to as shares in this Taxation Determination). Typically, a capital protected loan will either be a limited recourse loan or a full recourse loan, together with a put option. The capital protection feature means that the investor is effectively protected from the risk of a fall in the price of the shares as the associated put option enables the borrower to require the lender to take the shares in full repayment of the outstanding principal.

2. Interest is payable on the capital protected loan facility. Typically interest will either be payable annually in advance or monthly in arrears.[1]

[1] Where interest is paid in advance the prepayment provisions in Subdivision H of Division 3 of Part III of the *Income Tax Assessment Act 1936* will need to be considered.

3. Under a capital protected loan facility the investor may have the opportunity to use a '*call option writing feature*'. This feature allows an investor to sell call options over the underlying shares with a strike price that is greater than the capital protected amount of the loan.[2] Depending on the particular circumstances of the product, an investor may be restricted to writing call options to the issuer only, or may be able to write call options to unrelated third parties.

4. If the price of the shares increases above the strike price of the call option the holder of the call option may elect to exercise the option. When this occurs, the investor is obliged to sell the underlying shares to the option holder.[3]

5. An investor may have various choices with respect to the proceeds from the sale of the shares, although generally they are required to acquire further shares or repay the capital protected loan.

Determination

Drawdown of the capital protected loan facility

6. When the capital protected loan is first drawn down and the proceeds are used to acquire shares that are expected to produce dividends, the necessary nexus with the assessable income exists for the Interest outgoings to be deductible under section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997).

Granting of a call option

7. As selling call options under the option writing feature will not change the occasion of the Interest outgoings on the sum borrowed to acquire the shares, the nexus between the Interest expense and the assessable income will not be broken and Interest outgoings will continue to be deductible under section 8-1.

Call option exercised

8. If an investor subsequently sells the shares as a result of the call option being exercised it is necessary to determine whether the occasion of the Interest outgoing on the borrowed sum continues to be found in an income producing activity. The application of the proceeds of sale in an amount at least equal to the original loan amount to an income producing purpose maintains the necessary connection between the Interest outgoings on the originally borrowed sum and a relevant income producing activity.

9. That is, if income producing assets acquired with borrowed funds are sold and the proceeds of sale are used to acquire (a) new income producing asset(s) costing at least as much as the originally borrowed sum, the interest on the loan continues to be an allowable deduction. The funds used to acquire the original assets are now reflected in the new asset(s).

---

[2] Where the sold call option and the capital protection feature have the effect that the investor has materially diminished risks of loss or opportunities for gain in respect of the shares, the investor may not be a qualified person in relation to a distribution received and unless able to satisfy that requirement in another way, will not be entitled to a tax offset under section 207-20 of the ITAA 1997 in respect of the franked distribution.

[3] Acquisition of the shares on capital account will not necessarily mean that a subsequent disposal is on capital account. This will depend on the facts and circumstances relevant to each investor.

10. Accordingly, where proceeds equivalent to the loan amount are used to acquire further shares or remain in an income producing security deposit account, Interest outgoings will continue to be deductible under section 8-1.

11. Where the use of the borrowed funds has changed such that it can no longer be said that there is an income producing purpose, further Interest outgoings will not be deductible.

12. Should the capital protected loan allow proceeds to be withdrawn from the facility such that the amount reinvested in shares or in a security deposit account is less than the amount borrowed, Interest outgoings in respect of the originally borrowed amount will need to be apportioned.

Call option not exercised

13. Where the call option is not exercised, it subsequently lapses and the investor continues to hold the underlying shares, the nexus between the Interest outgoings and income producing activities remains and further Interest outgoings continue to be deductible under section 8-1.

Date of Effect

14. This Determination applies to years commencing both before and after its date of issue. However, it 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 the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
30 March 2005

Previous draft:
TD 2004/D89

Related Rulings/Determinations:
TR 92/20

Subject references:
- call option
- capital protected loan facility
- capital protected product
- interest deductibility
- limited recourse loan

Legislative references:
- TAA 1953 Pt IVAAA
- ITAA 1997 8-1
- ITAA 1997 207-20
- ITAA 1936 Pt III Div 3 Subdiv H

ATO references
NO: 2004/13633
ISSN: 1038-8982