TD 2004/D87 - Income tax: section 8-1 of the Income Tax Assessment Act 1997 : capital protected loan facility with a reset feature: interest deductibility

This document has been finalised by TD 2005/5.

Draft Taxation Determination

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

Preamble

This document is a draft for industry and professional comment. As such, it represents the preliminary, though considered views of the Australian Taxation Office. This draft may not be relied on by taxpayers and practitioners as it is not a ruling for the purposes of Part IVAAA of the ***Taxation Administration Act 1953****. It is only final Taxation Determinations that represent authoritative statements by the Australian Taxation Office.*

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 listed on the Australian Stock Exchange. Typically, a capital protected loan will either be a limited recourse loan or a full recourse loan together with a put option. The capital protected 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 borrowed sum.

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

3. Under the capital protected loan facility the investor may have the opportunity to '*reset*' the loan and/or the capital protection amounts where the underlying shares have increased or decreased in value.

Increase in value of the underlying shares

4. Where the value of an underlying share has increased, the investor may elect to have shares released from the mortgage equal to the value of the increase. The investor is then able to deal with those securities released from the mortgage in any manner they like, including disposing of them. The put option will be reset to apply only to those securities remaining subject to the mortgage.

5. Alternatively, the investor may increase the amount of the capital protected loan, or drawdown an additional loan, for an amount equal to the increase in value of the shares. The investor will receive the additional loan funds as a cash advance. The exercise price of the put option will be reset to an amount equal to the increased market value of the shares or a new put option issued.

Decrease in value of the underlying shares

6. Where the value of an underlying security has decreased, an investor may reset the loan amount to equal the reduced value of the shares. In this circumstance, the lender will repay part of the investor's capital protected loan for an amount equal to the decrease in value of the shares. The exercise price of the put option will be reset to the market value of the shares or a new put option issued.

7. Alternatively, the investor may choose to receive further securities. In this circumstance, the lender will acquire further securities equal to the decrease in value of the shares. These shares will be transferred to the Investor and will form part of the secured property. The put option will be reset to include the additional shares as part of the mortgage.

Determination

Drawdown of the capital protected loan

8. 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*.

Increase in value of the underlying shares

Release of shares from the mortgage

9. The release of the shares from the mortgage will not of itself break the nexus between the Interest outgoings and the income producing activity. A deduction will be allowable under section 8-1 for Interest outgoings incurred on a capital protected loan where some of the shares have been released from the mortgage under a reset feature provided the shares continue to be held by the borrower.

10. If the shares released from the mortgage are disposed of and the proceeds of sale are not reinvested as funds used to produce assessable income, Interest on the loan will have to be apportioned to reflect the pro-rata disposal of assets acquired by the original loan amount.

11. The extent to which income producing assets are charged/mortgaged is not a relevant consideration in determining the deductibility of Interest on funds borrowed to acquire the assets.

Additional loan funds

12. Where a borrower receives additional loan funds as a result of the shares' value increasing, this constitutes a new borrowing of funds. The receipt of additional loan funds will not break the nexus in respect of the original loan. Interest outgoings in respect of the original loan will continue to be deductible under section 8-1. The deductibility of Interest outgoings incurred in respect of the additional loan amount is determined by an examination of the use to which the funds are put. Interest outgoings will be deductible under section 8-1 to the extent that the additional loan funds are used for income producing purposes.

Decrease in value of underlying shares

13. If a borrower repays a part of their loan or receives additional shares as a result of a decrease in the share value, the nexus between the Interest outgoings and the activities producing the assessable income will not be affected. If a borrower were to in turn sell some or all of the additional shares received, the Interest on the original borrowing would not be affected. However income tax or capital gains tax consequences will arise for the borrower in respect of the disposal of those additional shares (as well as, of course, in respect of the disposal of any of the shares originally held). The cost of the additional shares for these purposes will be the market value of the shares at the time they were acquired.

Note 1: *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.*

Note 2: *Where interest is paid in advance the prepayment provisions in Subdivision H of Division 3 Part III of the Income Tax Assessment Act 1936 will need to be considered.*

Date of Effect

14. When the final Determination is issued, it is proposed to apply both before and after its date of issue. However, the Determination will 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 Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Your comments

15. We invite you to comment on this draft Taxation Determination. Please forward your comments to the contact officer by the due date.

Due date: **18 February 2005**

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Commissioner of Taxation
22 December 2004

Previous draft:

Not previously issued in draft form.

Related Rulings/Determinations:

TR 92/20

Subject references:

- capital protected loan facility
- capital protected product
- interest deductibility
- limited recourse loan
- reset feature

Legislative references:

- TAA 1953 Part IVAAA
- ITAA 1997 8-1
- ITAA 1936 Part III Div 3 Subdiv H

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