

# ***PR 1999/12 - Income tax: deductibility of interest incurred on borrowings under the Macquarie Sharemarket Lending Facility for the purchase of units in the Macquarie Enhanced Index Trust***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *5 December 2001*



## Product Ruling

# Income tax: deductibility of interest incurred on borrowings under the Macquarie Sharemarket Lending Facility for the purchase of units in the Macquarie Enhanced Index Trust

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### *Preamble*

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the Taxation Administration Act 1953. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

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

## What this Product Ruling is about

1. This Ruling sets out the Commissioner’s opinion on the way in which the ‘tax laws’ identified below apply to the defined class of persons who take part in the arrangement to which this Ruling relates. In this Ruling ‘the arrangement’ is the purchase of units in the Macquarie Enhanced Index Trust (‘the Enhanced Index Trust’) using monies borrowed from Macquarie Bank Limited (‘the Bank’) under the Macquarie Sharemarket Lending Facility (‘the Facility’).

### **Tax law(s)**

2. The tax laws dealt with in this Ruling are:
- section 8-1 of the *Income Tax Assessment Act 1997* (‘the 1997 Act’);
  - section 51AAA of the *Income Tax Assessment Act 1936* (‘the 1936 Act’);
  - section 82KJ of the 1936 Act;

- section 82KK of the 1936 Act;
- section 82KL of the 1936 Act;
- section 82KZM of the 1936 Act;
- sections 82KZMA, 82KZMB and 82KZMC of the 1936 Act;
- sections 82KZME and 82KZMF of the 1936 Act; and
- Part IVA of the 1936 Act.

## **Class of persons**

3. The class of persons to which this Ruling applies is those persons who enter into the arrangement described below on or after the date this Ruling is made. They will be parties entering into the arrangement with the purpose of deriving assessable income as a result of their investment (as set out in the description of the arrangement).
4. The class of persons to which this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.
5. The class of persons to which this Ruling applies does not include traders in investments and would not include persons treated for tax purposes as trading in units in the Enhanced Index Trust.

## **Qualifications**

6. The Ruling provides the specified class of persons with a binding ruling as to the tax consequences of the arrangement. The Commissioner accepts no responsibility in relation to the commercial viability of the arrangement. A financial (or other) adviser should be consulted for such information.
7. The Commissioner rules on the precise arrangement identified in the Ruling.
8. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 13 and 14) is carried out in accordance with the description in this Ruling. If the arrangement described in the Ruling is different from the arrangement that is actually carried out:
  - the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not that which was ruled upon; and

- the Ruling will be withdrawn or modified.

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## **Date of effect**

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10. This Ruling applies prospectively from 14 April 1999, the date this Ruling is made. However, the 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).

11. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, the Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## **Withdrawal**

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12. This Product Ruling is withdrawn on 1 July 2002 and ceases to have effect on and from that date. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the person's involvement in the arrangement.

## **Arrangement**

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13. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of

and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- application for a product ruling dated 24 March 1999, received from Baker & McKenzie on behalf of Macquarie Bank Limited;
- the Facility Brochure for the Macquarie Sharemarket Lending Facility (including loan application form and the Loan and Security Agreement);
- the Prospectus for the Macquarie Enhanced Index Trust with application form;
- the Constitution for the Macquarie Enhanced Index Trust; and
- the Deed of Trust for the Macquarie Australian Enhanced Equities Fund ('the Equities Fund').

14. The details of the arrangement are summarised as follows:

#### **The Facility**

The Bank is the provider of loans under the Facility to investors to fund the acquisition by investors of units in the Enhanced Index Trust.

Only Australian residents will be accepted under the Facility.

Subject to satisfying loan criteria, the Bank will lend the borrower (also referred to in this Ruling as the investor or unitholder) up to 80% of the cost of the units purchased in the Enhanced Index Trust. The loan will be in the form of the Macquarie Sharemarket Lending Facility. The investor will contribute the other 20% of the cost of the units. The minimum loan amount is \$20,000.

The loan is not subject to a fixed term but is available so long as the borrower complies with the loan term, including payment of interest or principal when due. At any time during the loan, the investor may apply for more units or request a full or partial redemption of their investment, subject to satisfying the current lending ratio.

The borrower provides security to the Bank in the form of a mortgage over all or part of the units purchased in the Enhanced Index Trust, or such other security approved by the Bank, including third party security. Restrictions apply to the borrower's dealings with the secured property.

Interest may not be capitalised. In the current climate, interest rates are expected to be in the range of 8.5% to 9% p.a.

The Facility enables a borrower to choose a variable interest rate, a 6 or 12 month fixed interest rate, and a combination of variable and fixed interest rates.

The Loan and Security Agreement of the Facility refers to the fixed interest rate and the combination of fixed and variable rates as a 'Split Rate Loan', i.e., where the loan is divided into two or more portions for the purpose of interest calculation. However, although there may be two portions with different interest rates, there is only one loan. This is evidenced by the fact that there is only one loan facility number, one loan statement provided to the borrower, and there is only one loan balance shown on the borrower's statement.

The borrower is required to maintain a specified lending ratio during the life of the loan. The lending ratio is calculated by dividing the loan balance by the market value of the units held in the Enhanced Index Trust. The maximum lending ratio is currently 80%. If the lending ratio exceeds 95%, the Bank may require the borrower to commence monthly principal payments representing 1% of the loan balance, until the lending ratio is restored to the authorised level.

The loan is also subject to specified events of default. Upon the occurrence of an event of default, the Bank is entitled to exercise certain rights in respect of the loan, including to require payment in full of the loan, sell the mortgaged units in the Enhanced Index Trust and sue the borrower to recover the debt. Accordingly, the loan is with full recourse to the borrower.

### **The Enhanced Index Trust**

The Enhanced Index Trust is a unit trust.

Only one class of units in the Enhanced Index Trust will be available for purchase by investors.

The majority of investors taking up units in the Trust will be individuals. There will also be investors using their companies or trusts to make the investment.

The assets of the Enhanced Index Trust will be 100% invested in the Equities Fund.

It is anticipated the Enhanced Index Trust will receive distributions of dividends, interest and realised gains from the Equities Fund. The Enhanced Index Trust will, in turn, make distributions to the unitholder. The distributions will be assessable income of the unitholder.

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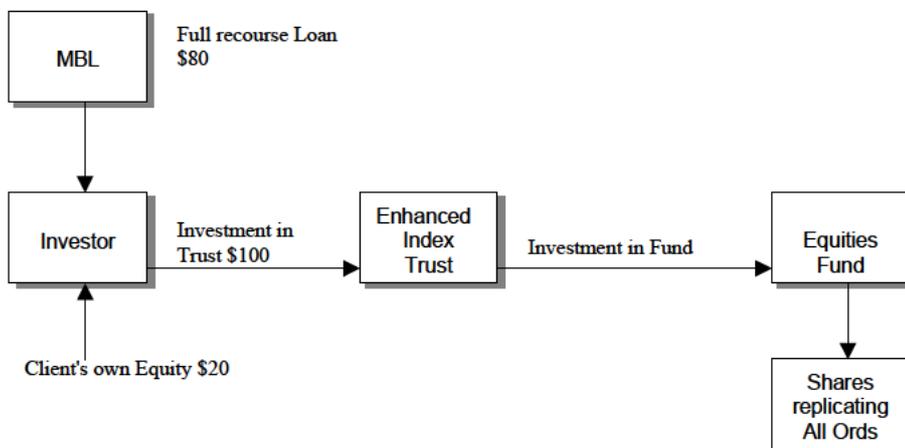
## The Equities Fund

The Equities Fund aims to replicate the performance of the ASX All Ordinaries Index. This is done by having 95% of the underlying assets of the Equities Fund replicating the All Ordinaries Index, that is, holding investments in every stock in the All Ordinaries Index. The strategy is to add value above the return of the All Ordinaries Index through a number of low risk enhancement techniques. These include:

- systematically enrolling in all available dividend reinvestment plans and receiving shares at a discount to market prices;
- taking advantage of the performance pattern of stocks entering and leaving the All Ordinaries Index;
- participating in share placements and floats;
- exploiting mispricing between different classes of shares issued by a company; and
- using sophisticated modelling to monitor stocks that may have been 'over bought' or 'oversold' because of lack of market liquidity.

These activities are performed within strict exposure limits using only around 5% of the funds portfolio.

Distributions of dividends, interest and realised gains realised on dealings in the Equities Fund investments, will be made by the Equities Fund to the Enhanced Index Trust.



## **Ruling**

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15. Subject to the assumptions listed in paragraph 16 of this Ruling:

- (a) a deduction is available to the investors under section 8-1 for interest incurred on borrowings under the Facility when used to purchase units in the Enhanced Index Trust;
- (b) a deduction for the interest incurred by an investor on borrowings under the Facility will not be barred by section 51AAA when used to fund the purchase of units in the Enhanced Index Trust;
- (c) the specific anti-avoidance provisions of the 1936 Act, specifically sections 82KJ, 82KK and 82KL, will not apply to deny deductibility of the interest incurred under the Facility in respect of borrowings used to fund the purchase of units in the Enhanced Index Trust;
- (d) section 82KZM of Subdivision H of Division 3 of Part III of the 1936 Act will not apply to deny immediate deductibility for prepaid interest expenditure incurred in respect of borrowings under the Facility used to fund the purchase of units in the Enhanced Index Trust where the expenditure is incurred:
  - (i) at or before 11.45 a.m. (by legal time in the Australian Capital Territory) on 21 September 1999; or
  - (ii) after 11.45 a.m. (by legal time in the Australian Capital Territory) on 21 September 1999 and during an income year commencing before 1 July 2001 and at least one of the following applies: the expenditure is (A) incurred by a small business taxpayer for the year of income; (B) incurred in meeting a pre-RBT obligation; (C) not incurred in carrying on a business; or
  - (iii) during an income year commencing after 30 June 2001 and at least one of the following applies: the expenditure is (A) incurred by an STS taxpayer for the year of income; (B) incurred in meeting a pre-RBT obligation; (C) incurred by an individual but not in carrying on a business.

Further, to obtain the deduction in full in the year of the prepaid interest being incurred the interest must be in respect of the making available or continued making available of the loan principal to which the interest relates for no longer than a period of 12 months after the day on which it is incurred and where (d)(iii) applies, the period ends no later than the last day of the income year following the income year in which the interest was incurred.

- (e) sections 82KZMA, 82KZMB and 82KZMC of the 1936 Act will apply to determine the amount and timing of deductions for prepaid interest expenditure incurred in respect of borrowings under the Facility used to fund the purchase of units in the Enhanced Index Trust where the expenditure is incurred:
  - (i) after 11.45 a.m. (by legal time in the Australian Capital Territory) on 21 September 1999 and during an income year commencing before 1 July 2001 by an investor (other than a small business taxpayer for the year of income) in carrying on a business; or
  - (ii) during an income year commencing after 30 June 2001 by an investor (other than an STS taxpayer for the year of income) who either carries on a business or is not an individual and does not carry on a business.
- (f) section 82KZMF of the 1936 Act will not apply to prepaid interest expenditure incurred by an investor in respect of borrowings under the Facility used to fund the purchase of units in the Enhanced Index Trust; and
- (g) the anti-avoidance provisions in Part IVA of the 1936 Act will not be applied to deny deductibility of any interest incurred by an investor in respect of borrowings used to fund the purchase of units in the Enhanced Index Trust.

## Assumptions

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16. This Ruling is made on the basis of the following necessary assumptions:

- (a) all of the investors are Australian residents;

- (b) the investors are not traders in investments and would not be treated for taxation purposes as trading in units in the Enhanced Index Trust;
- (c) the investors may or will derive assessable distributions from the Enhanced Index Trust representing dividends, interest and realised gains derived from the investments held by the Equities Fund;
- (d) the investors may derive capital gains on the appreciation of units of which they dispose in the Enhanced Index Trust, which will generally arise if there is an increase in the All Ordinaries Index;
- (e) any interest prepaid under the Facility of the loan principal by the Bank will not be for a period greater than 12 months;
- (f) the dominant purpose of an investor in entering the arrangement is to derive assessable income from their investment in the Enhanced Index Trust; and
- (g) the arrangement will be executed in the manner described under the **Arrangement** part of this Ruling.

## **Explanations**

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### **Section 8-1**

17. Interest on money borrowed to acquire income producing assets such as shares or units in a unit trust, is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

18. An investor in the arrangement will be required to use the funds borrowed under the Facility to acquire units in the Enhanced Index Trust. The units can be anticipated to produce dividends, interest and realised capital gains. Accordingly the funds borrowed are to be applied and used for a purpose of gaining or producing assessable income.

19. Accordingly, the interest incurred will be wholly deductible.

### **Section 51AAA**

20. Under the arrangement, it is contemplated that over the period of an investor's involvement there will be assessable income derived by way of dividend income, possibly interest income, as well as by way of capital gains.

21. Accordingly, section 51AAA has no application to an investor in the arrangement.

### **Subdivision H of Division 3 of Part III of the 1936 Act**

22.1 Subdivision H of Division 3 of Part III of the 1936 Act deals with the timing of deductions for certain prepaid expenditure. Separate rules apply depending on whether the expenditure is incurred in carrying on a business, whether the taxpayer is a 'STS taxpayer' and whether the expenditure qualifies for transitional treatment. The expenditure must be otherwise deductible under subsection 51(1) of the 1936 Act or section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997') and must not be 'excluded expenditure'. The rules in sections 82KZME-82KZMF do not apply to prepaid expenditure under an obligation which existed under an agreement before 1 p.m. (by legal time in the Australian Capital Territory) on 11 November 1999 which could not be avoided unilaterally by the taxpayer. The rules in sections 82KZMA-82KZMD do not apply to prepaid expenditure incurred in meeting a pre RBT obligation. 'Excluded expenditure' and 'pre-RBT obligation' are defined in subsection 82KZL(1) of the 1936 Act.

### **Sections 82KZM to 82KZMD: prepaid expenditure before and after Business Tax Reform**

22.2 Before the amendments ('the stage 1 amendments') inserted by the *New Business Tax System (Integrity and Other Measures) Act 1999*, expenditure made under an agreement entered into after 25 May 1988 was deductible in the year in which it was incurred ('the expenditure year') if it was for the doing of a thing that was to be done wholly within 13 months of the date of payment ('the 13-month rule'). Where section 82KZM applies, the deduction for the expenditure is spread over the lesser of the period during which the thing is to be done and 10 years ('the eligible service period' - see subsection 82KZL(1)).

22.3 The stage 1 amendments removed the 13-month rule after 11.45 a.m. (by legal time in the Australian Capital Territory) on 21 September 1999 for prepaid expenditure that does not meet a pre-RBT obligation and is incurred in carrying on a business by a taxpayer who is not a small business taxpayer (as defined in section 960-335 of the 1997 Act). Sections 82KZMA-KZMD, which set the amount and timing of relevant prepaid expenditure, include transitional rules to phase-in the initial impact of these amendments.

22.4 The rules in sections 82KZME and 82KZMF ('the stage 2 amendments') inserted by the *New Business Tax System (Integrity Measures) Act 2000* removed the 13-month rule for all taxpayers incurring prepaid expenditure after 1 p.m. (by legal time in the Australian Capital Territory) on 11 November 1999 in respect of certain investment schemes ('the 'tax shelter' type arrangements').

22.5 Further amendments ('the stage 3 amendments') brought about by the *New Business Tax System (Simplified Tax System) Act 2001* replaced the 13-month rule with a 12-month rule for certain classes of taxpayers. This new rule will apply to assessments for the first year of income commencing after 30 June 2001 and for later income years.

22.6 The 12-month rule allows an immediate deduction for prepaid expenditure where the expenditure is not excluded expenditure and is incurred for a period of service not exceeding 12 months and the period ends by the last day of the income year following the expenditure year. This 12-month rule applies only to taxpayers that are in the Simplified Tax System ('STS taxpayers'); or are individual taxpayers incurring deductible non-business expenditure; or are taxpayers incurring expenditure that meets a pre-RBT obligation.

22.7 An eligible taxpayer, who meets the criteria in section 328-365 of the 1997 Act for an income year, can notify the Commissioner of the choice to become a STS taxpayer. There are rules for entering and leaving the Simplified Tax System ('the STS'). Refer Subdivisions 328-F and 328-G of the 1997 Act.

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

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

22.9 Exception 5, as contained in subsections 82KZME(9) and (10), applies to exclude expenditure from the operation of section 82KZMF where the expenditure is under an agreement to which a product ruling (as defined in subsection 82KZME(11)) stating the expenditure as being allowable as a deduction applies. The product ruling must be made on or before 1 p.m. (by legal time in the Australian Capital Territory) on 11 November 1999, or in response to a product ruling application lodged with, and acknowledged by, the Commissioner on or before that time.

22.10 Given PR 1999/12 was made on 14 April 1999, prepaid interest expenditure incurred under the agreement covered by PR 1999/12 but incurred by the investor after 1 p.m. (by legal time in the Australian Capital Territory) on 11 November 1999 will be within Exception 5. The expenditure must then be considered under the other prepayment rules outlined above.

### **Section 82KJ**

23. Section 82KJ applies to tax avoidance agreements involving prepayment schemes where a taxpayer incurs interest, or other expenses with the aim of reducing the amount payable for the acquisition of property by the taxpayer or an associate. For section 82KJ to apply, the amount of the prepaid outgoing would be greater than, or, might reasonably expected to be greater than, the amount that would have been incurred in respect of the benefit obtained if the loss or outgoing had not been incurred as part of a tax avoidance agreement.

24. Section 82KJ will have no application to an investor in the arrangement. The property purchased by the taxpayer, be it either the proceeds of the loan funds or the units in the Enhanced Index Trust, is not acquired as a result or part of a tax avoidance agreement. The consideration for the property is no less than what it would have been if the interest outgoing had not been incurred.

### **Section 82KK**

25. Section 82KK will not have any application as in the circumstances there is no party receiving the interest payment which is an associate of the investor. An 'associate' is defined in section 82KH and no categories of that definition apply to Macquarie Bank Limited, the recipient of an interest prepayment of an investor.

### **Section 82KL**

25.1 The operation of section 82KL depends, among other things, on the identification of a certain quantum of 'additional benefits(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. Section 82KL will not apply to deny the deductions otherwise allowable under section 8-1.

### **Part IVA**

26. Provided that the arrangement is entered into and carried out as disclosed (see the **Arrangement** part of this Ruling), it would be accepted as a normal commercial transaction and Part IVA would not apply.

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**Detailed contents list**

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27. Below is a detailed contents list for this Ruling:

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**Commissioner of Taxation**

14 April 1999

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*Previous draft:*

No draft issued

*Related Rulings/Determinations:*

TR 92/1; TR 92/20; TR 95/33;  
TR 97/16; TD 93/34; PR 1998/1;  
PR 1999/12

# PR 1999/12

*Subject references:*

- financial products
- interest expenses
- product rulings
- public rulings
- tax avoidance
- taxation administration
- trusts
- unit trusts
- vendor finance

- ITAA36 82KZMC
- ITAA36 82KZMD
- ITAA36 82KZME
- ITAA36 82KZME(9)
- ITAA36 82KZME(10)
- ITAA36 82KZME(11)
- ITAA36 82KZMF
- ITAA36 Pt IVA
- ITAA97 8-1
- ITAA97 Subdiv 328-F
- ITAA97 328-365
- ITAA97 Subdiv 328-G
- ITAA97 960-335
- TAA53 Pt IVAAA
- Copyright Act 1968
- A New Business Tax System  
(Integrity and Other Measures) Act  
1999
- A New Business Tax System  
(Integrity Measures) Act 2000
- A New Business Tax System  
(Simplified Tax System) Act 2001

*Legislative references:*

- ITAA36 51(1)
- ITAA36 51AAA
- ITAA36 82KH
- ITAA36 82KJ
- ITAA36 82KK
- ITAA36 82KL
- ITAA36 Pt III Div 3 Subdiv H
- ITAA36 82KZL(1)
- ITAA36 82KZM
- ITAA36 82KZMA
- ITAA36 82KZMB

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