



# ***PR 2002/122 - Income Tax: deductibility of interest incurred on borrowings under the Westpac Protected Equity Loan***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *30 October 2002*



## Product Ruling

### Income Tax: deductibility of interest incurred on borrowings under the Westpac Protected Equity Loan

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Participants may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

#### *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 1999/95 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.*

#### **No guarantee of commercial success**

The Australian Taxation Office (ATO) **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.

Participants must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for participants by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, participants lose the protection of this Product Ruling. Participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Participants should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

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## Terms of use of this Product Ruling

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

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## What this Product Ruling is about

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1. This Ruling sets out the Commissioners 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 grant of a Put Option and the borrowing of moneys from Westpac Banking Corporation ('Westpac') to fund the acquisition of shares or units listed on the Australian Stock Exchange ('Shares') on the terms of a lending and share investment facility named the 'Westpac Protected Equity Loan' which is referred to in this Ruling as 'the PEL'.
2. This Ruling does not address the tax consequences of obtaining a further loan under the 'Top-up Loan' feature of the PEL or the extension of the PEL.
3. This Ruling does not address the tax consequences of the PEL arrangement being terminated early.

### Tax law(s)

4. The tax laws dealt with in this Ruling are:
  - section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - section 8-1 (ITAA 1997);
  - section 20-20 (ITAA 1997);
  - subsection 110-25(2) (ITAA 1997);
  - section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
  - section 82KL (ITAA 1936);
  - section 82KZM (ITAA 1936);
  - section 82KZMA (ITAA 1936);
  - section 82KZMB (ITAA 1936);
  - section 82KZMC (ITAA 1936);
  - section 82KZMD (ITAA 1936);

- section 82KZME (ITAA 1936);
- section 82KZMF (ITAA 1936); and
- Part IVA (ITAA 1936).

### **Class of persons**

5. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed and of deriving assessable income from their involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Investors'.

### **Qualifications**

6. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner. The Ruling will be withdrawn or modified.

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### **Date of effect**

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8. This Ruling applies prospectively from 30 October 2002. 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).

9. 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, this Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## **Withdrawal**

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10. This Product Ruling is withdrawn and ceases to have effect after 30 June 2006. 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, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

## **Arrangement**

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11. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- Application for a Product Ruling dated 31 May 2002 lodged by Allens Arthur Robinson on behalf of Westpac, amended by letter received from Allens Arthur Robinson dated 22 July 2002; and additional information provided on 19 September 2002 and 9 October 2002;
- Draft Information Memorandum lodged by Allens Arthur Robinson on behalf of Westpac on 21 October 2002; and
- Indicative Protected Equity Loan Term Sheet issued by Westpac ('Indicative Term Sheet'), dated 19 August 2002.

Each Investor will enter into the PEL Agreement with Westpac on or after the date of this Ruling.

12. The details and aspects of the arrangement subject to this Ruling are summarised as follows:

- (a) the PEL is a combined loan and option product by which Investors borrow funds from Westpac to finance the acquisition of four or more parcels of Shares in the Investor's name. The Shares are selected by an Investor from a range of Chess Approved Securities listed in the Indicative Term Sheet, or otherwise approved by Westpac;
- (b) each PEL is divided into a separate loan from Westpac for each parcel of Shares acquired by the Investor (each is a 'Loan');
- (c) the term of a PEL is three or five years and the minimum total of all Loan amounts is \$50,000, and thereafter in additional increments of \$25,000. A minimum of \$10,000 must be invested in each parcel of Shares and no more than 25% of the funds borrowed can be invested in each parcel;
- (d) the interest rate on the funds borrowed is a fixed 12 month interest rate. The initial 12 month fixed interest rate is indicated on the PEL Term Sheet current at the date the PEL application is accepted. The interest rate for subsequent 12 month terms will be notified by Westpac prior to the required payment date;
- (e) interest is payable annually in advance and is calculated by applying the applicable interest rate to the relevant Loan balance at the beginning of each period. Alternatively, an Investor may elect to pay monthly in arrears;
- (f) Investors may prepay the PEL prior to maturity. If this occurs, the Investor may be required to pay break costs;
- (g) on entering into a PEL, an Investor will be granted a put option by Westpac ('Put Option'). The Put Option allows the Investor to require Westpac to purchase a parcel of Shares at a price equal to the Investor's loan balance relating to that parcel of Shares. On exercise of the Put Option, the Put Option exercise price is applied against repayment of the outstanding Loan balance relating to that parcel of Shares;
- (h) the premium for the Put Option (being the 'Put Option premium') is payable by yearly or monthly (if applicable) instalments over the relevant term of the Loan (see paragraph 12(j) below);
- (i) the Put Option is exercisable on the Maturity Date of a Loan, and will expire in the event that:

- (i) the PEL Loan balances are repaid in full;
  - (ii) the PEL Loan balances are prepaid in full (including any break costs); or
  - (iii) the Put Option is not exercised on the Maturity Date of a Loan;
- (j) a portion of the interest payable on a PEL (excluding any interest attributable to a Top-up Loan, if any) is allocated as the Put Option premium. The Put Option premium will be published by Westpac and is applicable for the relevant interest payment period. The Put Option premium will be no less than the excess of the interest rate charged on the PEL above the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans. The Put Option premium will be calculated as a percentage of the interest rate, and will vary depending on the term of the PEL;
- (k) unless an Investor is in default, Westpac's recourse under each Loan is limited to the relevant parcel of Shares, the Put Option and the Deposit Account (see paragraph 12(o) below);
- (l) at the Maturity Date of a Loan, an Investor may:
  - (i) repay the total amount owing on one or more parcels of Shares;
  - (ii) extend the term of the PEL or instruct the Broker to sell one or more parcels of Shares (subject to Westpac's consent); or
  - (iii) if neither (i) or (ii) applies or the Put Option was not exercised by the Investor in respect of any part of the PEL, the Investor will be deemed to have exercised the Put Option on the Maturity Date of the Loan;
- (m) if the market value of a parcel of Shares increases by 15% or more, the Investor may request further advances under the PEL (referred to as a 'Top-up Loan') equal to the value of the increase, which must be used for business or investment purposes. A Top-up Fee is payable in relation to each Top-up Loan;
- (n) a Top-up Loan may relate to more than one parcel of Shares, but must be more than \$5,000 in respect of each parcel. A Top-up Loan is repayable on the same date as the PEL to which it relates, and interest on the

Top-up Loan is calculated at the same fixed rate as applicable to the PEL;

- (o) as the legal and beneficial owner of the Shares, Investors will be entitled to all dividends and capital gains. However, any of the following in relation to the Shares must be held in an account opened by Westpac on the Investor's behalf ('Deposit Account'):
  - (i) cash returns on capital;
  - (ii) extraordinary dividends;
  - (iii) proceeds from the disposal or relinquishment of rights; and
  - (iv) proceeds in relation to options granted to or by the Share Owner.

The Deposit Account is solely for the purposes of the PEL and cannot be operated by the Investor;

- (p) depending on their individual circumstances, Investors receive the benefit of any rebates or credits attaching to any dividends received in respect of the Shares, subject to the 'at risk' holding period rules applying generally to shares;
- (q) if any of the Shares are:
  - (i) bought back under a buy-back scheme;
  - (ii) subject to a takeover, merger, or reconstruction; or
  - (iii) the subject of a proposed bonus issue, share split, consolidation, scheme of arrangement or any other arrangement affecting rights in relation to the Shares,

the Investor may be required to repay a portion of the PEL balance, replace the affected Shares, deposit cash or take other actions in order to restore the value of Westpac's loan security. In any one of these circumstances, interest prepaid annually in advance may be refunded in part, to the Investor;

- (r) brokerage, taxes, costs, charges and commissions in relation to the purchase and sale of Shares, and the preparation of the PEL documentation, including any stamp duty, are payable by the Investor; and
- (s) each PEL is secured by a mortgage in favour of Westpac over the Shares, any dividends, distributions,



bonus shares and rights issues relating to the Shares, and the Put Option.

## The Participants

13. Westpac is the provider of the Loans to Investors under the PEL to fund the acquisition of the Shares.
14. The Investors may be individuals, companies or trusts.

## Ruling

15. Subject to the assumptions listed in paragraph 16 of this Ruling:
  - (a) part of the 'interest' charged under the PEL is a Put Option premium. The Put Option premium is a capital protection fee and is not deductible under section 8-1 of the ITAA 1997;
  - (b) for Investors entering the PEL for a term of 3 years, the interest charge allowable under section 8-1 of the ITAA 1997 is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – Fixed rate or 80% of the total interest charged by Westpac under the PEL;
  - (c) for Investors entering the PEL for a term of 5 years, the interest charge allowable under section 8-1 of the ITAA 1997 is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – Fixed rate or 85% of the total interest charged by Westpac under the PEL;
  - (d) the amount of interest on each Loan that is not deductible under the formulae described in paragraphs 15(b) and (c) above represents the consideration paid in instalments by an Investor for the acquisition of the relevant Put Option, and is included in the Investor's cost base for that Put Option under subsection 110-25(2) of the ITAA 1997;
  - (e) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction for the PEL interest charge allowable under section 8-1 of the ITAA 1997;
  - (f) section 82KL, a specific anti-avoidance provision of the ITAA 1936, will not apply to deny deductibility of

the PEL interest charge allowable under section 8-1 of the ITAA 1997;

- (g) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the interest charge incurred under the PEL;
- (h) section 82KZM of the ITAA 1936 will not apply to deny an Investor immediate deductibility of that part of the PEL interest charge allowable under section 8-1 of the ITAA 1997 where at least one of the following applies for the year of income:
  - the Investor is an STS taxpayer; or
  - the Investor is an individual who does not incur the interest charge in carrying on a business;
- (i) sections 82KZMA 82KZMB, 82KZMC and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for that part of the PEL interest charge that is deductible to an Investor (other than an STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not carry on a business;
- (j) any refund of prepaid interest received by the Investor will be assessable income to the Investor under section 6-5 or section 20-20 of the ITAA 1997; and
- (k) the anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor on the PEL borrowings used to fund the purchase of Shares.

## **Assumptions**

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

- (a) all of the Investors are Australian residents;
- (b) the Investors are not traders in investments and are not treated for taxation purposes as either trading in the Shares or carrying on a business of investing in the Shares. Further, the Investors do not otherwise hold the Shares as revenue assets;
- (c) in respect of any interest charges to be paid in advance under the PEL lending agreement, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less that ends on or before the

last day of the income year following the expenditure year;

- (d) the dominant purpose of an Investor entering into the arrangement is to derive assessable income comprising dividends and capital gains from their investment in the Shares;
- (e) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;
- (f) all dealings by Investors and Westpac will be at arm's length; and
- (g) the Investors will not prepay the loan prior to maturity or terminate the arrangement early.

## **Explanations**

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### **Section 8-1 of the ITAA 1997**

17. The cost (or interest paid) of a borrowing to acquire income producing assets such as shares 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. In the arrangement under this product, the part of the interest payments under the PEL that are allocated to the consideration for the Put Option is the Put Option premium. The Put Option premium ensures that the borrower is protected from liability to repay the principal of the loan if the market value of the Shares falls below their original purchase price. In effect, the Put Option ensures that Westpac will acquire the Shares in full satisfaction of the loan if the Shares have fallen in value below the amount borrowed. Accordingly, the Put Option premium is a capital protection fee and is not deductible under section 8-1.

19. The ATO is of the view that the Put Option premium is not deductible because it is incurred for a purpose other than to service or maintain the borrowed funds. The Put Option premium is capital in nature, being paid to acquire an asset, namely, the Put Option.

20. Investors should only claim deductions equal to the amount of interest determined as follows:

- (a) for Investors entering a PEL for a term of 3 years - the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans - Fixed or 80% of the total interest charged by Westpac; or

- (b) for Investors entering a PEL for a term of 5 years - the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans - Fixed or 85% of the total interest charged by Westpac.

**Cost base of Put Option – subsection 110-25(2) of the ITAA 1997**

21. That amount which is not deductible to the Investor under section 8-1 of the ITAA 1997 forms the cost base of a Put Option under subsection 110-25(2) and constitutes an asset for capital gains tax purposes which is separate and in addition to the other rights created under the PEL as described in this Ruling.

**Section 51AAA of the ITAA 1936**

22. By investing in the PEL, it is contemplated that an Investor will derive assessable income by the receipt of dividend or trust income and capital gains. Accordingly, the interest would have been deductible under section 8-1 of the ITAA 1997 irrespective of whether the capital gain is included in assessable income. Accordingly, section 51AAA has no application to an Investor in the PEL.

**Section 82KL of the ITAA 1936**

23. The operation of section 82KL 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 a deduction otherwise allowable under section 8-1 of the ITAA 1997.

**Subdivision H of Division 3 of Part III of the ITAA 1936**

24. This Subdivision 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 an 'STS taxpayer', whether the Investor is an individual, whether the taxpayer is not an individual and incurs the expenditure otherwise than in carrying on a business and whether the expenditure qualifies for transitional treatment. This Subdivision does not apply to 'excluded expenditure' which is defined in subsection 82KZL(1) to include amounts of less than \$1,000 or amounts of expenditure that are of a capital nature.

***Subdivisions 328-F & 328-G of the ITAA 1997 - STS taxpayer***

25. An Investor will be an STS taxpayer for an income year if the Investor is eligible to be an STS taxpayer for that year and the Investor notifies the Commissioner of the choice to become such a taxpayer for that year.

26. An Investor will be eligible to be an STS taxpayer for an income year if the Investor carries on a business and the STS average turnover of the business and related business for that year is less than \$1 million and the business and related businesses have depreciating assets with a total adjustable value below \$3 million at the end of that year.

***The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the ITAA 1936***

27. The PEL interest charge allowable under section 8-1 of the ITAA 1997 is in relation to a prepayment of loan interest for a period that is not more than 12 months. Paragraph 82KZL(2)(a) 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, 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 not more than 12 months, and not to the period of the loan, which may be three or five years under the PEL.

***Sections 82KZME and 82KZMF of the ITAA 1936: prepaid expenditure and 'tax shelter' arrangements***

28. The rules in sections 82KZME and 82KZMF 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.

29. For the purposes of section 82KZME, '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 PEL, including the financing, Shares purchase, Shares holding and disposal arrangements.

30. Exception 1, as contained in subsection 82KZME(5), applies to exclude the interest incurred on borrowings under the PEL from the operation of section 82KZMF, as:

- (i) the prepaid interest expenditure under the PEL, that does not represent the Put Option premium, is incurred in respect of money borrowed to acquire Shares that are listed for quotation on the Australian Stock Exchange;
- (ii) the Investor can reasonably be expected to obtain dividend or trust income from the investment;
- (iii) the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- (iv) all aspects of the PEL are at arm's length.

Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 31 to 37 below.

***Section 82KZM of the ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure***

31. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a taxpayer that is either:

- (i) an STS taxpayer for the year of income; or
- (ii) a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

32. The expenditure must not be excluded expenditure and must be incurred otherwise than in carrying on a business. Section 82KZM 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.

33. As the eligible service period in relation to the deductible interest payment under the PEL is not more 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 will have no application to Investors who are STS taxpayers 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 allowable PEL interest incurred.

***Sections 82KZMA - 82KZMD of the ITAA 1936: prepaid non-business expenditure incurred by non-individual and non-STS taxpayers***

34. Sections 82KZMA, 82KZMB, 82KZMC and (in respect of income years after the income year including 21 September 2002) section 82KZMD set the amount and timing of deductions for expenditure for an Investor (other than an STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not incur the expenditure in carrying on a business.

35. 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.

36. For these taxpayers, the deduction for prepaid interest on the borrowings under the PEL will be apportioned over the relevant interest payment period, subject to the transitional provisions in section 82KZMB (applying to expenditure incurred before or during the Investor's year of income that includes 21 September 2002).

37. Section 82KZMD will not apply to an Investor in respect of interest payments on the borrowings under the PEL incurred before or during the Investor's year of income that includes 21 September 2002 as the eligible service period to which the interest payments relate will end not more than 13 months after the expenditure is incurred.

**Section 6-5 and/or section 20-20 of the ITAA 1997**

38. Any refund of prepaid interest received by an Investor will be included in the assessable income of the Investor pursuant to section 6-5 as it will be income according to ordinary concepts or alternatively will be an assessable recoupment under section 20-20.

**Part IVA of the ITAA 1936**

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

**Detailed contents list**

40. Below is a detailed contents list for this Product Ruling:

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**Commissioner of Taxation**

30 October 2002

*Previous draft:*  
*Not previously issued in draft form.*

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

*Related Rulings/Determinations:*

*Subject references:*



# PR 2002/122

- financial products
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- Legislative references:*
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  - ITAA 1997 110-25(2)
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## ATO References

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