



# ***PR 2002/41 - Income tax: deductibility of interest incurred on borrowings under the Commonwealth Bank Protected Portfolio Loan***

 This cover sheet is provided for information only. It does not form part of *PR 2002/41 - Income tax: deductibility of interest incurred on borrowings under the Commonwealth Bank Protected Portfolio Loan*

 This document has changed over time. This is a consolidated version of the ruling which was published on *24 April 2002*



## Product Ruling

### Income tax: deductibility of interest incurred on borrowings under the Commonwealth Bank Protected Portfolio Loan

Contents	Para
What this Product Ruling is about	1
Date of effect	7
Withdrawal	9
Arrangement	10
Ruling	14
Assumptions	15
Explanations	16
Detailed contents list	37

Potential 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 laws**, **Class of persons** and **Qualifications sections**), **Date of effect**, **Withdrawal**, **Previous Ruling**, **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 products are 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. 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 potential 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 arrangements are not carried out as described below, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangements will be carried out as described in this Product Ruling.

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

#### **Terms of use of this Product Ruling**

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.

## What this Product Ruling is about

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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 person who takes 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 Commonwealth Bank of Australia ('CBA') to fund the acquisition of a portfolio of Australian shares on the terms of a lending and share investment facility named the 'Commonwealth Bank Protected Portfolio Loan' which is referred to in this Ruling as 'the PPL'.

### Tax law(s)

2. The tax laws dealt with in this Ruling are:
- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
  - section 82KL of ITAA 1936;
  - section 82KZM of ITAA 1936;
  - sections 82KZMA, 82KZMB, 82KZMC of ITAA 1936;
  - sections 82KZME, 82KZMF of ITAA 1936;
  - Division 108 of Part 3-1 of ITAA 1997;
  - subsection 110-25(2) of ITAA 1997; and
  - Part IVA of ITAA 1936.

### Class of persons

3. 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**

4. The Commissioner rules on the precise arrangement identified in the Ruling.

5. 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, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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### **Date of effect**

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7. This Ruling applies prospectively from 24 April 2002, 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).

8. 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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9. This Product Ruling is withdrawn and ceases to have effect after 30 June 2005. 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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10. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- amended Application for a Product Ruling dated 7 February 2002, letter dated 7 February 2002 received from CBA and additional information provided on 14 March 2002;
- the PPL Offer Circular prepared and issued by CBA included as an attachment with the letter dated 7 February 2002. The Offer Circular also includes the Application for Finance Form, Loan Agreement, Mortgage Agreement, Sponsorship Agreement and Nominee Agreement; and
- indicative PPL Term Sheet and indicative PPL Information Sheet prepared and issued by CBA, included as an attachment with the letter dated 7 February 2002.

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

- (a) The PPL involves the granting of a Put Option and the making of a loan to an Investor for a fixed term of either one, two, three, four or five years ('the Loan'). The funds provided under the Loan are used to finance 100% of the purchase price of a portfolio of Australian shares to be acquired by the Investor. The shares will be selected from a CBA approved list of ASX listed shares.
- (b) The gains and losses on each of the selected shares in the portfolio are treated separately.
- (c) The minimum loan amount is \$50,000 and each subsequent loan amount must be at least \$25,000.
- (d) Interest on the Loan in the PPL with a fixed rate is payable annually in advance. Alternatively, Investors can choose to pay the interest monthly in arrears at a variable rate.
- (e) Part 6 of the Offer Circular provides an Investor with a Put Option to sell each type of share in the portfolio for

the principal outstanding under the Loan which relates to that share. The Put Option may only be exercised by the Investor not later than five Business Days prior to the maturity of the Loan. Each Put Option granted to the Investor may be exercised independently of each other Put Option (for example, if one of the shares in the portfolio falls in value, the Investor can exercise their Put Option for that share but need not exercise their Put Options for the other shares in the portfolio).

- (f) The rate of interest charged by CBA to customers borrowing under the PPL varies according to the term of the loan, with the shorter the period of the loan and the more volatile the price of shares, the higher the rate of interest charged. Investors can choose from a fixed or variable interest rate.
- (g) A portion of the interest payments is allocated to the Put Option premium. This is the greater of the excess on the interest rate charged on the Loan above the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans, or the relevant percentage of the interest rate specified in paragraph 14(b) below.
- (h) A share brokerage fee and stamp duty will apply whenever the Investor purchases or sells shares.
- (i) Early termination of the PPL will incur an additional fee.
- (j) For the purposes of securing the rights of CBA under the PPL, the Investor shall deal with the shares as CBA may specify (Part 1, Clause 17(a)). Limited trades on shareholdings are subject to CBA's consent (Part 1, Clause 18(a)). Any proceeds from the sale of shares will be applied on the Investor's behalf to acquire units in a widely held unit trust of the type described in subsection 82KZME(5)(b)(iii) of ITAA 1936 ('the Approved Unit Trust') until the termination of the PPL or are used to repurchase an identical number and type shares (Part 1, Clause 18(c)).
- (k) The Loan is a limited recourse loan (Part 2, Clause 6). Under this term of the Loan, CBA is only entitled to enforce its rights as mortgagee in relation to the principal of the loan against the shares held as security. In the event that the market price of the shares purchased with the loan falls below the original cost of those shares, Investors may give notice, at any time during the term of the Loan or following the occurrence

of an Event of Default, asking CBA to exercise its rights as mortgagee of the shares (Part 2, Clause 6(f)). As such, Investors are never required to repay the difference between the market value of the shares and the principal borrowed.

- (l) Upon maturity of the loan, Investors may:
  - (i) repay the loan; or
  - (ii) ask CBA to exercise its rights as mortgagee of the shares; or
  - (iii) exercise their right to put the shares to CBA under the Put Option.
- (m) If the value of the shares at maturity of the Loan is greater than the principal borrowed, Investors will, after the payment of the facility fee, make a profit.
- (n) Any dividends paid in respect of the shares purchased under the PPL are paid to the Investors.
- (o) The Investors receive the benefit of any rebates or credits attaching to any dividends received, subject to the at-risk holding period rules applying generally to shares acquired after 1 July 1997.
- (p) Any dividends paid during the period of the Loan and reinvested as part of a Dividend Reinvestment Plan will be retained by the Investors at the expiry of the Loan.
- (q) Bonus shares issued will be held by CBA on the Investors' behalf and will form part of the security for the PPL. At the expiry of the Loan, should the market value of the original shares and any bonus shares be below the cost of the original parcel of shares, both the original and bonus shares will be released to CBA.

## The Participants

12. CBA is the provider of the Loans to Investors under the PPL to fund the acquisition of ASX listed shares.

13. The Investors may be individuals, companies and trusts.

## Ruling

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

- (a) Part of the 'interest' charged under the PPL is a capital protection fee and is not deductible under section 8-1 of ITAA 1997;
- (b) The PPL interest charge allowable under section 8-1 of ITAA 1997 is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or the relevant percentage of the total interest charged by CBA as follows:
  - (i) for Loans with a term of 1 year, 60%;
  - (ii) for Loans with a term of 2 years, 72.5%;
  - (iii) for Loans with a term of 3 years, 80%;
  - (iv) for Loans with a term of 4 years, 82.5%; and
  - (v) for Loans with a term of 5 years, 85%.

If the interest rate charged on the Loan is a fixed rate, the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans - fixed is used. If the interest rate charged on the Loan is a variable rate, the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans - variable is used;

- (c) The amount of interest on each Loan that is not deductible under the formula described in paragraph 14(b) 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 ITAA 1997;
- (d) Section 51AAA of ITAA 1936 will not apply to deny an Investor a deduction for the PPL interest charge allowable under section 8-1 of ITAA 1997;
- (e) Section 82KL, a specific anti-avoidance provision of ITAA 1936, will not apply to deny deductibility of the PPL interest charge allowable under section 8-1 of ITAA 1997;
- (f) Section 82KZM of ITAA 1936 will not apply to deny immediate deductibility for the PPL interest charge incurred by the Investor and at least one of the following applies for the year of income:
  - (i) the Investor is an STS taxpayer; or
  - (ii) the Investor is an individual who does not incur the expenditure in carrying on a business;

- (g) Sections 82KZMA, 82KZMB and 82KZMC of ITAA 1936 will apply to determine the amount and timing of deductions for the PPL interest charge incurred by an Investor (other than an STS taxpayer for the year of income) who either:
  - (i) carries on a business; or
  - (ii) is a taxpayer that is not an individual and does not carry on a business;
- (h) Section 82KZMF of ITAA 1936 will not apply to set the amount and timing of deductions for the PPL interest charge; and
- (i) The anti-avoidance provisions contained in Part IVA of ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor in respect of borrowings used to fund the purchase of shares.

## Assumptions

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15. 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 are not treated for taxation purposes as either trading in shares or carrying on a business of investing in 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 PPL, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less that ends by the last of day of the income year following the expenditure year;
  - (d) The Investors will derive assessable income from the investment in the shares. That assessable income will not include income other than trust income, dividends and capital gains receipts;
  - (e) The dominant purpose of an Investor in entering the arrangement is to derive assessable income from their investment in the shares;
  - (f) The arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;

- (g) All dealings by the Investors and CBA will be at arm's length; and
- (h) The Investors will not terminate the arrangement early.

## **Explanations**

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

16. The cost (or interest paid) of a borrowing used 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).

17. The ATO view expressed in media release Nat 99/26 is that part of the 'interest' charged under the PPL is a capital protection fee and is not deductible under section 8-1. The ATO considers that the purpose of this fee is to give the taxpayer capital protection in the event of a share price fall.

18. Investors should only claim deductions equal to the amount of interest determined as follows – the lower of the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans (fixed or variable) or the applicable percentage set out in paragraph 14(b) above.

19. The ATO is of the view that the part of the interest payments under the Loan allocated to the consideration for the Put Option (being the 'Put Option premium') is a capital protection fee and is not deductible under section 8-1. The ATO view is that the capital protection fee is not deductible because it is incurred for a purpose other than to service or maintain the borrowed funds. The fee is capital in nature, being paid to acquire an asset, namely, the Put Option.

20. The Put Option premium ensures that the borrower is protected from liability to repay the principal if the market value of the shares falls below their original purchase price. In effect, the Put Option ensures that CBA will acquire the shares in full satisfaction of the loan amount if the shares have fallen in value below the amount borrowed. Accordingly, the consideration paid for the acquisition of the Put Option is a capital protection fee.

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

## **Section 51AAA of ITAA 1936**

22. Under the PPL, it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income as well as by way of capital gain. Accordingly, the interest would have been deductible under section 8-1 irrespective of whether the capital gain is included in assessable income. Accordingly, section 51AAA has no application to an investor in the PPL Facility.

## **Section 82KL of ITAA 1936**

23. Section 82KL will not have any application as this section applies to deny a deduction for a tax benefit in certain situations arising out of a tax avoidance agreement. The PPL is not a tax avoidance arrangement.

## **Subdivision H of Division 3 of Part III of 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 a 'STS taxpayer', whether the Investor is an individual 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.

## **Subdivision 328-F & G of ITAA 1997 - STS taxpayer**

25. An Investor will be a STS taxpayer for an income year if the Investor is eligible to be a 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 a 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 ITAA 1936**

27. The PPL interest charge allowable under section 8-1 is in relation to a prepayment of loan interest for a period that is 12 months or less. Subparagraph 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 one year, and not to the period of the loan (except for a one year loan), which may be either two, three, four or five years under the PPL.

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

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

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

and the expenditure is not excluded expenditure.

29. The section 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, in full, under section 8-1.

30. As the eligible service period in relation to the deductible PPL interest is 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 PPL interest incurred.

**Sections 82KZMA - 82KZMC of ITAA 1936: prepaid business expenditure incurred by non-STS taxpayers and prepaid non-business expenditure incurred by non-individuals and non-STS taxpayers**

31. Sections 82KZMA, 82KZMB and 82KZMC set the amount and timing of deductions for expenditure for an Investor (other than a STS taxpayer for the year of income) who:

- (a) carries on a business; or
- (b) is a taxpayer that is not an individual and that does not carry on a business.

The expenditure must not be excluded expenditure and must be either incurred in carrying on a business, or incurred otherwise than in carrying on a business by a taxpayer that is not an individual. The expenditure 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.

32. Sections 82KZMB, 82KZMC and 82KZMD operate to spread the deduction for the expenditure over the relevant eligible service period. Sections 82KZMA-82KZMC include transitional rules for phasing out the benefit of the immediate deductibility of such prepayments.

**Sections 82KZME and 82KZMF of ITAA 1936 - prepaid expenditure and 'tax shelter' type arrangements**

33. 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' type arrangement for the doing of a thing that is not to be wholly done within the expenditure year.

34. For the purposes of section 82KZME, 'agreements' are broadly defined to include an entire arrangement of which a contract may form part. Under sub-section 82KZME(4), the relevant 'agreement' is all the contractual arrangements and activities associated with the participation in the PPL, including the financing, share purchase, share holding and disposal arrangements.

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

- (a) the prepaid interest expenditure under the PPL is incurred in respect of money borrowed to acquire shares that are listed for quotation on the Australian Stock Exchange, or units in a trust as described in subparagraph 82KZME(5)(b)(iii);

- (b) the Investor can reasonably be expected to obtain dividends or trust income from the investment;
- (c) the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- (d) all aspects of the PPL are at arm's length.

Accordingly, the tax shelter prepayment rules will not apply to Investors. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 24–32 above.

### **Part IVA of ITAA 1936**

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

## **Detailed contents list**

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

	<b>Paragraph</b>
<b>What this Product Ruling is about</b>	<b>1</b>
Tax law(s)	2
Class of persons	3
Qualifications	4
<b>Date of effect</b>	<b>7</b>
<b>Withdrawal</b>	<b>9</b>
<b>Arrangement</b>	<b>10</b>
The Participants	12
<b>Ruling</b>	<b>14</b>
<b>Assumptions</b>	<b>15</b>
<b>Explanations</b>	<b>16</b>
Section 8-1 of ITAA 1997	16
Section 51AAA of ITAA 1936	22
Section 82KL of ITAA 1936	23
Subdivision H of Division 3 of Part III of ITAA 1936	24
Subdivisions 328F & G of ITAA 1997 – STS taxpayer	25

The eligible service period for the purposes of Subdivision H of Division 3 of Part III of ITAA 1936	27
Section 82KZM of ITAA 1936 Act: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure	28
Sections 82KZMA - 82KZMC of ITAA 1936: prepaid business expenditure incurred by non-STs taxpayers and prepaid non-business expenditure incurred by non-individual and non-STs taxpayers	31
Sections 82KZME and 82KZMF of ITAA 1936 - prepaid expenditure and 'tax shelter' type arrangements	33
Part IVA of ITAA 1936	36
<b>Detailed contents list</b>	<b>37</b>

**Commissioner of Taxation**

24 April 2002

<i>Previous draft:</i>	- ITAA 1936 82KZM
Not previously released in draft form	- ITAA 1936 82KZMA - ITAA 1936 82KZMB
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZMC
PR 1999/95; TR 92/1; TR 92/20; TR 95/33; TR 97/16; TD 93/34	- ITAA 1936 82KZMD - ITAA 1936 82KZME - ITAA 1936 82KZME(4) - ITAA 1936 82KZME(5) - ITAA 1936 82KZME(5)(b)(iii)
<i>Subject references:</i>	- ITAA 1936 82KZMF
- financial products	- ITAA 1936 Pt IVA
- interest expenses	- ITAA 1997 8-1
- repaid expenses	- ITAA 1997 Div 108 Pt 3-1
- product rulings	- ITAA 1997 Div 110 Pt 3-1
- public rulings	- ITAA 1997 110-25(2)
- STS taxpayer	- ITAA 1997 Div 328 Pt 3-45
- taxation administration	- ITAA 1997 Subdivision 328-F - ITAA 1997 Subdivision 328-G
- tax avoidance	- ITAA 1997 Subdiv H of Div 3 Pt III
<i>Legislative references:</i>	- Copyright Act 1968
- ITAA 1936 51AAA	
- ITAA 1936 82KL	
- ITAA 1936 82KZL(1)	
- ITAA 1936 82KZL(2)(a)	

ATO references:

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