



PR 2002/87 - Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment (plus shared upside)

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 This document has changed over time. This is a consolidated version of the ruling which was published on *12 June 2002*



Product Ruling

Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment (plus shared upside)

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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 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.

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 this product 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 arrangement is 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 arrangement will be carried out as described in this Product Ruling.

Potential 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.

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

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 Macquarie Bank Limited ('the Bank') to fund the acquisition of shares listed on the Australian Stock Exchange and/or units of a widely held unit trust on the terms of a lending and investment facility named the 'Macquarie Geared Equities Investment (plus shared upside)' which is referred to in this Ruling as the 'GEI plus'. A Call Option may also be granted by the borrower for a reduced rate of interest under this arrangement.
2. This Ruling does not address the tax deductibility of interest (or other costs) incurred on a loan advanced against an existing portfolio of shares.
3. This Ruling does not address the tax implications of converting the GEI plus to a Margin Loan.

Tax law(s)

4. The tax laws dealt with in this Ruling are:
 - section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
 - section 104-10 (ITAA 1997);
 - section 104-40 (ITAA 1997);
 - paragraph 104-25(1)(c) (ITAA 1997);
 - Division 110 (ITAA 1997);
 - Division 115 (ITAA 1997);
 - Division 116 (ITAA 1997);
 - Division 134 (ITAA 1997);
 - section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KJ (ITAA 1936);
 - section 82KK (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.

7. 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

9. This Ruling applies prospectively from 12 June 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).

10. 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

11. 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

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

- application for a Product Ruling dated 22 January 2002 as amended by letter dated 28 May 2002 received from Baker & McKenzie on behalf of Macquarie Bank Ltd;
- letter from Macquarie Bank Limited dated 27 May 2002;
- the Macquarie Geared Equities Investment (plus shared upside) Risk Disclosure Declaration, Loan and Security Agreement and Call Option Deed attached to Baker & McKenzie's letter dated 28 May 2002; and
- draft Macquarie Geared Equities Investment (plus shared upside) application form.

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

- (a) Under the GEI plus, the Investor borrows funds from the Bank to finance the purchase of certain listed shares and/or units in widely held unit trusts as defined in section 272-105 in Schedule 2F to the ITAA 1936;

- (b) the Investors are required to select shares up to the amount of funds borrowed from the Bank from a list of publicly listed shares which is provided to the Investor when they receive the GEI Plus application form. The minimum loan amount is \$50,000 with subsequent drawings and/or purchases being in parcels of at least \$50,000;
- (c) the term of the loan may be either one, two, three, four or five years. Interest is payable monthly in arrears on a variable basis, and each year Investors have the option to fix their interest rate and prepay interest for a 12 month period. Alternatively, Investors may fix their interest rate for 1 or more years and pay interest either annually in advance, or monthly in arrears;
- (d) the Bank will calculate a different rate of interest for each share an Investor may invest in. The interest rate will also depend upon the term of the loan. The shorter the period of the loan and the greater the risk to the Bank given the security offered by the shares, the higher the rate of interest charged;
- (e) a share brokerage fee and stamp duty (if applicable) will apply whenever the Investor purchases or sells shares. Registration fees and legal fees may also be payable;
- (f) there may also be costs associated with an early unwind of the facility;
- (g) for the purpose of securing the rights of the Bank under the GEI Plus, the Investor grants a mortgage to the Bank over the acquired shares and related rights. The Investor must also deal with the shares as the Bank may specify. Limited trades (no more than two trades per year) on shareholdings are subject to the Bank's consent (clause 23.2 of the Loan and Security Agreement). Any proceeds from the sale of shares are to be held in a blocked income earning cash management trust until termination of the GEI plus or the repurchase of the shares;
- (h) Clause 22 of the GEI plus Loan and Security Agreement provides for a limited recourse facility. As such, the Bank is only entitled to enforce its rights as mortgagee in relation to the principal of the loan against the shares held as security. If, when the loan matures, the then market value of the shares purchased with the loan proceeds is below the original cost of those shares, the Investor may give notice that it will

require the Bank to exercise its rights as mortgagee of the shares under the Put Option described in paragraph (i) below;

- (i) the Put Option contained in clause 22 of the Loan and Security Agreement, as part of the limited recourse arrangement, operates such as to give the Investor the right to transfer to the Bank any shares purchased with the loan where the market value of those shares has fallen below the original acquisition cost of those shares. The price payable by the Bank to the Investor for that share transfer is the amount of the loan borrowed by the Investor to purchase such shares. The Bank is entitled to set-off payment of that price against the obligations of the Investor to repay that component of the loan;
- (j) a portion of the interest payable on the loan is allocated to the Put Option premium. The Put Option premium is no less than the excess of the interest rate charged on the loan 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 loan;
- (k) the GEI plus also contains a Call Option feature. Under the Call Option, the Investor grants to the Bank an option to purchase the shares when the loan matures if the value of the shares increases to an amount in excess of 150% of the original purchase price;
- (l) Investors must choose at the time of entering into the Loan and Security Agreement whether or not they will also grant the Call Option. If an Investor selects to enter into the Call Option, they will be charged a lesser interest rate in relation to the loan than would have been applicable if the Call Option feature had not been selected;
- (m) if an Investor elects to enter into the Call Option, they must also choose, prior to loan drawdown, what percentage of increase in the value of the shares in excess of 150% of the original purchase price will be used to calculate the Exercise Price (being the amount payable on the exercise of the Call Option) or the 'Interest Reduction Fee'. An Investor may select 0%, 25%, 50% or 100% as the relevant percentage. The level of reduction of the interest rate in relation to the loan will depend on the level of percentage nominated

for the purposes of the Call Option – the larger the percentage, the larger the interest rate reduction on the loan. Because of this, the payment is called an Interest Reduction Fee;

- (n) no fee is charged by the Investor when it grants the Call Option to the Bank;
- (o) the Exercise Price payable by the Bank to the Investor on exercise of the Call Option is calculated as;

$$I + (P \times MV)$$

Where: I = an amount representing 150% of original acquisition cost of the Relevant Securities

P = the Nominated Percentage; and

MV = the additional increase in market price of the Relevant Securities in excess of 150% of the original acquisition cost of the Relevant Securities.

- (p) if upon maturity of the loan the market price of the shares is in excess of 150% of the original purchase price, the Investor may cash settle the Call Option arrangement rather than transferring ownership of the shares to the Bank;
- (q) where the Investor chooses to cash settle the Call Option, it must repay the loan in full using its own funds (being either personal or borrowed funds). In these circumstances, the Investor must also pay to the Bank using its own funds the Interest Reduction Fee calculated as:

$$SG - (I + (P \times MV))$$

Where: SG = the Market Value of the Relevant Securities at the date that is 3 Business Days prior to the Final Maturity Date;

I = an amount representing 150% of original acquisition cost of the Relevant Securities;

P = the Nominated Percentage; and

MV = the additional increase in market price of the Relevant Securities in excess of 150% of the original acquisition cost of the Relevant Securities.

- (r) an Investor who has entered into a Call Option with the Bank will not be permitted to perform limited trades in relation to shares which are security for the loan;

- (s) the Investor shall repay the loan to the Bank in one amount on Final Maturity Date. At least five clear Business Days before the Final Maturity Date the Investor must inform the Bank either:
 - (i) the Investor will repay all or part of the loan on Final Maturity Date; and/or
 - (ii) the Investor intends to exercise the Put Option; or
 - (iii) the Investor requests the loan be converted to a Margin Loan facility.
- (t) any dividends paid in respect of the shares purchased under the GEI plus are paid to the Investor;
- (u) the Investor receives 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;
- (v) any dividends paid during the period of the loan and reinvested as part of a Dividend Reinvestment Plan will initially form part of the security for the GEI plus and will be retained by the Investor at the expiry of the loan;
- (w) bonus shares issued will form part of the security for the GEI plus. 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 subject to the Put Option described in paragraphs 13(i) above.

The Participants

14. The Bank is the provider of loans under the GEI plus to Investors to fund the acquisition of approved shares.

15. The majority of investors will be individuals. There will also be investors using companies or trusts to make an investment in the GEI plus.

Ruling

16. Subject to the assumptions listed in paragraph 17 of this Ruling:

- (a) as part of the 'interest' charged under the GEI plus is a premium for a Put Option, it is a capital protection fee and is not deductible under section 8-1 of the ITAA 1997;
- (b) the GEI plus 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 or the relevant percentage of the total interest charge by the Bank under the GEI plus as follows:
 - (i) 60% (for Loans with a term of one year);
 - (ii) 72.5% (for Loans with a term of two years);
 - (iii) 80% (for Loans with a term of three years);
 - (iv) 82.5% (for Loans with a term of four years); or
 - (v) 85% (for Loans with a term of five years).

Where the interest rate charged on a loan is a variable rate the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans Variable is to be used, and where the interest rate charged is a fixed rate the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans Fixed is to be used;

- (c) the amount of the interest on the loan that is not deductible under the formula described in paragraph 16(b) above represents the payment of a premium for the Put Option by instalments and becomes part of the cost base of the Put Option under subsection 110-25(2) of the ITAA 1997;
- (d) any Interest Reduction Fee paid is not deductible under section 8-1 of the ITAA 1997;
- (e) section 51AAA of the ITAA 1936 will not apply to deny the GEI plus interest charge allowable under section 8-1 of the ITAA 1997;
- (f) sections 82KJ, 82KK and 82KL will not apply to deny deductibility of the interest incurred under the GEI plus;
- (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 GEI plus;
- (h) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of the GEI plus interest charge allowable under section 8-

1 of the ITAA 1997 where 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 taxpayer 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 the GEI plus interest charge that is deductible to 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.
- (j) if the Investor exercises the Put Option at the end of the loan term, the cost of the Put Option will be added to the cost base of the shares but the Investor will recoup from the cost base of the shares the amount of the loan used to acquire the shares. Any gain or loss on exercise of the Put Option will be disregarded;
- (k) if the Investor does not exercise the Put Option, the Investor will make a capital loss equal to the amount paid to acquire the Put Option;
- (l) the grant of the Call Option by the Investor to the Bank is a CGT event which does not result in a capital gain or a capital loss;
- (m) if the Bank exercises the Call Option and the Investor transfers shares to it, the Investor will make a capital gain equal to the capital proceeds received from the Bank less the Investor's cost base in the shares. The proceeds received by the Investor from the Bank will equate to the market value of the shares less the percentage of the increase the Investor has agreed to forgo. The proceeds will thus equate to the Exercise Price;
- (n) if the Investor repays the loan and sells shares to fund the repayment, the Investor will make a capital gain on selling the shares equal to the sale proceeds less the cost base of the shares;
- (o) if the Investor borrows additional funds to repay the loan but retains the ownership of the shares, the payment of the Interest Reduction Fee based on the

agreed percentage of increase in value of the shares in excess of 150% of purchase price will form part of the cost base of the shares for capital gains tax purposes; and

- (p) the anti-avoidance provisions in Part IVA of the 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 under the GEI plus.

Assumptions

17. 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 acquired under the GEI plus. 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 GEI plus, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less and which ends on or before the last day of the income year following the expenditure year;
- (d) the Investors may or will derive assessable income from the shares acquired under the GEI plus, but that assessable income will not include income other than trust income and dividends, and capital gains receipts;
- (e) the dominant purpose of an Investor in entering the arrangement is to derive assessable income from their shares acquired under the GEI plus;
- (f) the arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;
- (g) all dealings by the Investors and the Bank under the GEI plus will be at arm's length; and
- (h) the Investors will not prepay the loan under the GEI plus prior to maturity or terminate the arrangement early.

Explanations

Section 8-1 of the ITAA 1997

18. 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).

19. In the arrangement under this Product, part of interest payments under the loan are allocated to the consideration for the Put Option (being the 'Put Option Premium'). The Put Option Premium ensures that the borrower is protected from liability to repay the principal if the market value of the shares acquired under the GEI plus falls below their original purchase price. In effect, the Put Option ensures that the Bank 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.

20. 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.

21. Investors should only claim deductions equal to the amount of interest on the loan determined as follows - the lower of the applicable Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or the applicable interest amounts as calculated in accordance with the formula described in paragraph 16(b) above.

22. 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 GEI plus as described in this Ruling.

23. The Interest Reduction Fee is not deductible under section 8-1. The payment of the Interest Reduction Fee will be added to the cost base of the shares for capital gains tax purposes.

Section 51AAA of the ITAA 1936

24. Under the GEI plus it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income or trust 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, or, more precisely, a deduction would have been allowable irrespective of whether the capital gain has been included in

assessable income. Accordingly, section 51AAA has no application to an Investor in the GEI plus.

Section 82KJ of the ITAA 1936

25. 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. As the consideration for the acquisition of shares under the GEI plus is no less than what it would have been if the interest outgoing had not been incurred, section 82KJ will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Section 82KK of the ITAA 1936

26. 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 the Macquarie Bank Limited, the recipient of an interest prepayment of an Investor.

Section 82KL of the ITAA 1936

27. 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 the deductions otherwise allowable under section 8-1 of the ITAA 1997.

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

28. 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 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 and Subdivision 328-G of the ITAA 1997 –
STS taxpayer*

29. 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.

30. 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*

31. The interest deductible under section 8-1 of the ITAA 1997 is in relation to a prepayment of loan interest for a period that is 12 months or less. 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 and not to the period of the loan.

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

32. 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.

33. 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 GEI plus, including the financing, share and/or unit purchase, share and/or unit holding and disposal arrangements.

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

- (a) the prepaid interest expenditure under the GEI plus 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 GEI plus are at arm's length.

35. 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 36 to 41 below.

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

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

- (a) an STS taxpayer for the year of income; or
- (b) is a taxpayer that is not an individual and that does not carry on a business,

and the expenditure is not excluded expenditure.

37. 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 under section 8-1 of the ITAA 1997.

38. As the eligible service period in relation to the 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 interest incurred.

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

39. Sections 82KZMA, 82KZMB, 82KZMC, and (in respect of income years after that 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:

- (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.

40. For these taxpayers, the deduction for prepaid interest on the loan 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).

41. Section 82KZMD will not apply to an Investor in respect of interest payments on the loan 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.

Put Option and Cost Base

42. While the cost of the capital protection is not deductible to the Investor under section 8-1 of the ITAA 1997 (refer to paragraph 20 above), pursuant to subsection 110-25(2) of the ITAA 1997 it forms the cost base of the Put Option acquired by the Investor which constitutes an asset for capital gains tax purposes and which is separate and in addition to the other rights created under the GEI Plus as described in this Ruling. If the Investor exercises the Put Option at the end of the loan term by transferring title to the shares to the Bank in satisfaction of the loan, any gain or loss on exercise of the Put Option is disregarded (subsection 134-1(4) of the ITAA 1997). The Investor will add the payment for acquiring the Put Option to the cost base of the shares disposed to the Bank (subsection 134-1(1), item 2 of the ITAA 1997) but will recoup from the cost base of the shares the

amount of the loan used to acquire the shares (subsection 110-45(3) of the ITAA 1997).

43. If the investor does not exercise the Put Option by the time the loan expires, the investor will make a capital loss at that time, equal to the cost base of the Put Option. (CGT Event C2, paragraph 104-25(1)(c) of the ITAA 1997).

Call Option

44. Under the arrangement the Investor grants the Bank a Call Option such that when the loan matures and the market price of the shares is greater than 150% of the purchase price, the Investor is required to transfer the shares to the Bank at the agreed Exercise Price or cash settle the Call Option obligations by paying the Interest Reduction Fee to the Bank.

45. The grant of the Call Option by the investor to the Bank will not result in a capital gain or loss arising for the Investor.

46. Before the Bank issues the Call Option Notice, the Investor can elect to either;

- (a) transfer ownership of the shares to the Bank; or
- (b) cash settle the Call Option obligations.

Where the Investor chooses to transfer ownership of the shares to the Bank, CGT event A1 will happen in relation to the disposal of the shares. Where the capital proceeds of the disposal exceeds the cost base of the shares, the Investor will make a capital gain. The cost base for the shares will equate to the purchase price plus any incidental costs of ownership such as stamp duty (if applicable).

47. The capital proceeds the Investor receives when they deliver their shares will equate to the market value of the shares less the percentage of the increase the Investor has agreed to forgo (the Exercise Price). The percentage forgone will equate to the Interest Reduction Fee.

48. Alternatively, the Investor may choose to cash settle the Call Option and to repay the loan either by;

- (a) selling the shares themselves and using these funds to repay the loan;
- (b) not selling the shares but using their own funds to repay the loan; or
- (c) borrowing further funds from the Bank and refinancing the original loan.

49. The sale of the shares by the Investor will be the disposal of a CGT asset. The Investor will make a capital gain if the proceeds from

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the disposal are more than the share's cost base. They will make a capital loss if those proceeds are less than the share's reduced cost base.

50. If the Investor does not sell the shares, but uses their own funds or borrows to repay the loan, or refinances the original loan, the Investor will be required to pay the Interest Reduction Fee to the Bank. This payment is capital expenditure made to preserve the Investor's title to the shares and it will form part of the shares' cost base (subsection 110-25(6) of the ITAA 1997).

Part IVA of the ITAA 1936

51. 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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Commissioner of Taxation

12 June 2002

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Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 95/33,
TR 97/16; TD 93/34; PR 1999/95
Subject references:

- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- small business taxpayer
- taxation administration
- tax avoidance

Legislative references:

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- ITAA 1936 51AAA
- ITAA 1936 82KJ

- ITAA 1936 82KK
- ITAA 1936 82KL
- ITAA 1936 82KZL(1)
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