



PR 2005/27 - Income tax: tax consequences of investing in QuantumWarrants - 2005 Product Disclosure Statement

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 This document has changed over time. This is a consolidated version of the ruling which was published on *16 March 2005*



Product Ruling

Income tax: tax consequences of investing in QuantumWarrants – 2005 Product Disclosure Statement

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Preamble

*The number, subject heading, **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 Tax Office **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 and how the product fits an existing portfolio. 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 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, 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 Tax Office 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.

Potential participants may wish to refer to the Tax Office website at www.ato.gov.au or contact the Tax Office directly to confirm the currency of this Product Ruling or any other Product Ruling that the Tax Office has issued.

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' 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 acquisition of a QuantumWarrant which provides an investment in real estate using a loan made by QuantumWarrants Pty Ltd (Quantum).
2. This Ruling does not address the tax consequences of:
 - drawing down additional loan amounts; or
 - a rollover or extension of the term of the QuantumWarrant.

Tax law(s)

3. The tax laws dealt with in this Ruling are:
 - section 8-1 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - section 25-25 of the ITAA 1997;
 - section 104-10 of the ITAA 1997;
 - section 109-5 of the ITAA 1997;
 - subsection 110-45(3) of the ITAA 1997;
 - section 115-5 of the ITAA 1997;
 - section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936);
 - section 82KL of the ITAA 1936;
 - section 82KZM of the ITAA 1936;
 - section 82KZMA of the ITAA 1936;
 - section 82KZMD of the ITAA 1936;
 - section 82KZME of the ITAA 1936;
 - section 82KZMF of the ITAA 1936;
 - section 97 of the ITAA 1936; and
 - Part IVA of the ITAA 1936.

Class of persons

4. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date of this Ruling. They will have, at the time of entering into the arrangement, the 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 those persons are referred to as 'Investors'.

Qualifications

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

6. 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

8. This Ruling applies prospectively from 16 March 2005, 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).

9. If a taxpayer has a more favourable private ruling (which is legally binding) the taxpayer can rely upon 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 extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

10. This Product Ruling is withdrawn and ceases to have effect after 30 June 2008. 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

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

- application as amended 22 September 2004 received from Robert Richards & Associates on behalf of Quantum;
- additional information dated 7 December 2004 and 14 February 2005; and
- draft Product Disclosure Statement for QuantumWarrants dated 25 January 2005 prepared and issued by Quantum (PDS) which incorporates the following documents:
 - draft pro forma Quote Request Form to be completed by the Investor;
 - draft pro forma Application Form to be completed by Investors wishing to acquire QuantumWarrants;
 - draft Instalment Deed to be executed by Quantum and Quantum Nominees Pty Limited (as Security Trustee);
 - draft Security Deed to be executed by the Security Trustee;

- draft pro forma Loan Agreement to be executed by the Investor and Quantum; and
- draft pro forma Management Deed to be executed by the Investor and Quantum Management Services Pty Limited (the Manager).

12. In this Ruling, unless otherwise defined, capitalised terms take their meaning per the PDS.

13. The details of the arrangement the subject of this Ruling are summarised as follows:

- (a) a QuantumWarrant is a leveraged investment under which an Investor acquires a beneficial interest in real property (the Property) using a limited recourse loan (the Loan) made by Quantum. The term of the investment and the Loan is 10 years;
- (b) the Loan amount is determined by Quantum having regard to the value of the Property. The Loan amount will be set between 10% and 80% of the value of the Property;
- (c) repayment of the Loan is secured by a mortgage over the Property. Legal title to the Property is held by the Security Trustee on trust for the Investor. Each Property is held on separate trust and there is no pooling of interests or property to which the trust relates;
- (d) the Loan is provided on a limited recourse basis such that Quantum's right to repayment of the Loan is limited to the amount it can obtain by enforcing its right in respect of the mortgage;
- (e) on making the Completion Payment, the Loan owing to Quantum will be repaid and the mortgage over the Property will be discharged. The Security Trustee will deliver legal title to the Property to the Investor;
- (f) interest is payable annually in advance for the period to the next Annual Reset Date or the Maturity Date, as applicable (Annual Interest);
- (g) a Borrowing Fee is payable to Quantum at the time of application for providing the Loan;
- (h) the Manager will enter into a lease for the Property with the Security Trustee prior to the Security Trustee acquiring legal title to the Property. The Manager will sub-lease the Property to tenants at market rates;
- (i) the Manager will manage the Property and will pay the rates, taxes, insurances, repairs and maintenance and other such expenses in respect of the management of the Property from gross sub-lease rentals;

- (j) during the life of the QuantumWarrant, Investors will be entitled to all net rental income. There will be no other income in respect of the Property; and
- (k) at maturity of the QuantumWarrant, the Investor has 3 options:
 - (i) pay the Completion Payment:
the Loan is repaid, the mortgage extinguished and legal title to the Property is delivered to the Investor;
 - (ii) rollover:
a rollover is equivalent to the Investor extending the term of the QuantumWarrant; or
 - (iii) do nothing:
if the Completion Payment is not made at the Maturity Date, the Property will be sold and any surplus from the net proceeds after repayment of the Loan and costs will be paid to the Investor.

The Participants

- 14. QuantumWarrants Pty Ltd (Quantum) is the issuer of QuantumWarrants and also the provider of Loans to the Investor to fund the acquisition of the Property.
- 15. Quantum Nominees Pty Limited holds the legal title to each Property as Security Trustee and as nominee for each Investor.
- 16. Quantum Management Services Pty Limited (the Manager) is responsible for the overall management of the Property.
- 17. The Investors may be individuals, companies, trusts or superannuation funds.

Ruling

- 18. Subject to the assumptions listed in paragraph 19 of this Ruling:
 - (a) the Annual Interest incurred under the Loan Agreement will be deductible to the Investor under section 8-1 of the ITAA 1997;
 - (b) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction for the Annual Interest allowable under section 8-1 of the ITAA 1997;
 - (c) section 82KL of the ITAA 1936 will not apply to deny a deduction for the Annual Interest allowable under section 8-1 of the ITAA 1997;

- (d) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the Annual Interest incurred under a QuantumWarrant;
- (e) section 82KZM of the ITAA 1936 will not apply to deny immediate deductibility for the Annual Interest incurred by the Investor under a QuantumWarrant where at least one of the following applies for the year of income:
- the Investor is a Simplified Tax System (STS) taxpayer; or
 - the Investor is an individual who does not incur the expenditure in carrying on a business;
- (f) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for the Annual Interest incurred under a QuantumWarrant for an Investor (other than an STS taxpayer for that year of income) who is a taxpayer that is not an individual and does not carry on a business;
- (g) the Borrowing Fee charged on application is deductible under section 25-25 of the ITAA 1997 over five years;
- (h) for capital gains tax (CGT) purposes the date of acquisition of the Property under section 109-5 of the ITAA 1997 is the date on which the Security Trustee entered into the contract for the acquisition of the Property;
- (i) no CGT event arises when the legal title to the Property is transferred from the Security Trustee to the Investor on cancellation or redemption of a QuantumWarrant by virtue of subsection 104-10(7) of the ITAA 1997;
- (j) a CGT event will arise under section 104-10 of the ITAA 1997 to the Investor where the Completion Payment is not made and the Property is sold by Quantum exercising its power of sale of the Property. If the sale proceeds are insufficient to repay the Loan Quantum has no recourse against the Investor to recover the shortfall. In this circumstance, the cost base of the Property will be reduced by the excess (if any) of the Loan amount over the market value of the Property under subsection 110-45(3) of the ITAA 1997;
- (k) any capital gain realised by an Investor on sale of the Property pursuant to the completion of a QuantumWarrant, will be treated as a discount capital gain under section 115-5 of the ITAA 1997 where the Investor is an individual, a complying superannuation entity, or a trust and has held the QuantumWarrant for at least 12 months;

- (l) all of the income derived from the Property will be included in the assessable income of the Investor (and not the Security Trustee) under section 97 of the ITAA 1936; and
- (m) the anti-avoidance provisions contained in Part IVA of the ITAA 1936 will not apply to deny deductibility of the Annual Interest incurred by an Investor in respect of the QuantumWarrant.

Assumptions

19. This Ruling is made on the basis of the following assumptions:
- (a) all of the Investors are Australian residents for taxation purposes;
 - (b) the Investor is not a trader in real estate and will not be treated for income tax purposes as either trading in the Property or carrying on a business of investing in the Property, or holding the Property as a revenue asset;
 - (c) the Annual Interest for each interest payment period may be prepaid by the Investor but only in relation to interest payment periods 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 in entering into the arrangement is to derive assessable income from their investment in the QuantumWarrant;
 - (e) the arrangement will be executed in the manner described in the Arrangement section of this Ruling;
 - (f) the Property will not be sub-leased to the Investor or an associate of the Investor;
 - (g) the Investor or an associate of the Investor will not occupy the Property; and
 - (h) all dealings between Investors, Quantum, the Manager and tenants will be at arm's length.

Explanation

Section 8-1 of the ITAA 1997

20. The interest paid on a borrowing used to acquire assets, such as a Property, which is used to derive assessable income is generally treated as deductible under section 8-1 where it is expected that assessable income will be derived from the investment (see Taxation Ruling TR 95/33).

Section 51AAA of the ITAA 1936

21. By investing in QuantumWarrants it is contemplated that an Investor will derive income by the receipt of rental income and capital gains. As the Annual Interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of any net capital gain in assessable income, section 51AAA has no application to an Investor in QuantumWarrants.

Section 82KL of the ITAA 1936

22. The operation of section 82KL depends, among other things, on the identification 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

23. 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 upon 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 Investor is not an individual and incurs the expenditure otherwise than in carrying on a business. This Subdivision does not apply to 'excluded expenditure' which is defined in subsection 82KZL(1) of the ITAA 1936 as amounts of less than \$1,000, or amounts of expenditure that are of a capital nature.

Subdivision 328-F and Subdivision 328-G of the ITAA 1997 – STS taxpayer

24. 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.

25. 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 businesses 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

26. The interest allowable as a deduction under section 8-1 of the ITAA 1997 is in relation to a pre-payment of loan interest for a period that is not more than 12 months. Paragraph 82KZL(2)(a) of the ITAA 1936 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 12 months or less, and not to the period of the Loan, which is 10 years.

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

27. The rules in sections 82KZME and 82KZMF apply, subject to the exceptions in section 82KZME, where the 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.

28. 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 a QuantumWarrant, including the financing, Property purchase and disposal arrangements.

29. Under the arrangement, when the Investor acquires a QuantumWarrant, the Investor acquires beneficial ownership of the Property.

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

- the Annual Interest is incurred in respect of money borrowed to acquire real property;
- the Investor can reasonably be expected to obtain rental income from the investment;
- the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- all aspects of the QuantumWarrants are at arm's length.

31. Deductibility of expenditure must therefore be considered under the prepayment rules outlined at paragraphs 32 to 37.

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

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

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

33. The expenditure must not be excluded expenditure and must be incurred otherwise than in the carrying on of 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.

34. As the eligible service period in relation to the deductible interest for QuantumWarrants 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 Annual Interest incurred.

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

35. Sections 82KZMA and 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.

36. The expenditure must not be excluded expenditure and must be incurred in return for the doing of a thing under an agreement that it is not to be wholly done within the expenditure year.

37. For these taxpayers, the deduction for the prepaid Annual Interest will be apportioned over the relevant interest payment period.

Section 25-25 of the ITAA 1997: Borrowing Fee

38. The Borrowing Fee relates to the cost of Quantum making the Loan available to the Investor. As the Loan funds are used for income-producing purposes and the Loan term is 10 years, any Borrowing Fee charged on application will be deductible over 5 years under section 25-25.

Section 109-5 of the ITAA 1997: time of acquisition

39. Section 109-5 applies to Investors to treat them as having acquired the Property at the time that the Security Trustee enters into the contract for the acquisition of the Property.

Subsection 104-10(7) of the ITAA 1997: time of disposal

40. When the Completion Payment is made, no CGT event will arise in respect of the transfer of legal title to the Property from the Security Trustee to the Investor by virtue of subsection 104-10(7).

Section 104-10 of the ITAA 1997: CGT event A1

41. A CGT event will arise to the Investor if the Investor does not make the Completion Payment and the Property is sold. If the sale proceeds are insufficient to repay the Loan there is no recourse against the Investor to recover the shortfall. In this circumstance the Investor will need to reduce the cost base of the Property by the amount of the shortfall in accordance with subsection 110-45(3) of the ITAA 1997.

Section 115-5 of the ITAA 1997: CGT discount

42. Division 115 of the ITAA 1997 allows a taxpayer a discount on capital gains in certain circumstances. In accordance with section 115-5, any capital gain realised by an Investor on the sale of the Property pursuant to the completion of a QuantumWarrant, will be treated as a discount capital gain where the Investor is an individual, a complying superannuation entity, or a trust and has held the QuantumWarrant for at least 12 months.

Section 97 of the ITAA 1936

43. The Investors are presently entitled to all of the income derived from the Property. Therefore, section 97 will apply to assess the Investors on the income derived from the Property. The Security Trustee will not be subject to tax on this income.

Part IVA of the ITAA 1936

44. Provided the arrangement ruled on is entered into and carried out as disclosed, (see the Arrangement part of this Ruling), it is accepted that the arrangement is an ordinary commercial transaction and Part IVA will not apply.

Detailed contents list

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Commissioner of Taxation

16 March 2005

<i>Previous draft:</i>	- ITAA 1936 82KZL(1)
Not previously issued as a draft	- ITAA 1936 82KZL(2)(a)
	- ITAA 1936 82KZM
<i>Related Rulings/Determinations:</i>	- ITAA 1936 82KZMA
TR 92/1; TR 92/20; TR 95/33;	- ITAA 1936 82KZMD
TR 97/16; TD 93/34; PR 1999/95	- ITAA 1936 82KZME
	- ITAA 1936 82KZME(4)
<i>Subject references:</i>	- ITAA 1936 82KZME(5)
- financial products	- ITAA 1936 82KZMF
- interest expenses	- ITAA 1936 97
- prepaid expenses	- ITAA 1936 Pt IVA
- product rulings	- ITAA 1997 8-1
- public rulings	- ITAA 1997 25-25
- small business taxpayer	- ITAA 1997 104-10
- taxation administration	- ITAA 1997 104-10(7)
- tax avoidance	- ITAA 1997 109-5
	- ITAA 1997 110-45(3)
	- ITAA 1997 115-5
<i>Legislative references:</i>	- ITAA 1997 Subdiv 328-F
- TAA 1953 Pt IVAAA	- ITAA 1997 Subdiv 328-G
- ITAA 1936 51AAA	- Copyright Act 1968
- ITAA 1936 82KL	
- ITAA 1936 Pt III Div 3 Subdiv H	

ATO references

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