



# ***PR 2007/101 - Income tax: deductibility of interest incurred on borrowings under the Leveraged Equities Share Protection Plan***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *12 October 2011*



## Product Ruling

# Income tax: deductibility of interest incurred on borrowings under the Leveraged Equities Share Protection Plan

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### **ⓘ This publication provides you with the following level of protection:**

This publication (excluding appendixes) is a public ruling for the purposes of the *Taxation Administration Act 1953*.

A public ruling is an expression of the Commissioner's opinion about the way in which a relevant provision applies, or would apply, to entities generally or to a class of entities in relation to a particular scheme or a class of schemes.

If you rely on this ruling, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are not prevented from doing so by a time limit imposed by the law). You will be protected from having to pay any underpaid tax, penalty or interest in respect of the matters covered by this ruling if it turns out that it does not correctly state how the relevant provision applies to you.

## **No guarantee of commercial success**

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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. 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 scheme is carried out in accordance with the information we have been given, and have described below in the **Scheme** part of this document. If the scheme is not carried out as described, participants lose the protection of this Product Ruling.

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

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

## What this Ruling is about

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1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling section (below) apply to the defined class of entities, who take part in the scheme to which this Ruling relates. In this Product Ruling the scheme is referred to as the Leveraged Equities Share Protection Plan (SPP).
2. This Ruling does not address the tax consequences of:
  - undertaking limited trades of the acquired shares under the terms of the SPP;
  - interest (or other costs) incurred on a loan advanced against an existing portfolio of shares;
  - rollover of the protected shares into a new SPP at maturity;
  - conversion of all or part of a protected loan to Leveraged Equities Margin Loan; and
  - investing in any other products promoted by Leveraged Equities Limited (LEL).

### Class of entities

3. The class of entities who can rely on this Product Ruling consists of those entities that are accepted to participate in the scheme specified below on or after 19 December 2007 which is the date of publication of this Ruling and which execute relevant agreements mentioned in paragraph 18 of this Ruling on or before 30 June 2010. They must have a purpose of staying in the scheme until it is completed (that is being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement. These entities are referred to as Investors.

### Superannuation Industry (Supervision) Act 1993

4. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA 1993). The Tax Office gives no assurance that the product is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product Ruling as to whether investment in this product may contravene the provisions of SISA 1993.

**Qualifications**

5. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is in accordance with the scheme described in paragraphs 18 and 19 of this Ruling.

6. If the scheme actually carried out is materially different from the scheme that is described in this Product Ruling, then:

- this Product Ruling has no binding effect on the Commissioner because the scheme entered into is not the scheme on which the Commissioner has ruled; and
- this Product Ruling may be withdrawn or modified.

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**Date of effect**

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8. This Product Ruling applies prospectively from 19 December 2007, the date of publication of this Ruling. It therefore applies to the specified class of entities that enter into the scheme from 19 December 2007 until 30 June 2010, being its period of application. This Product Ruling will continue to apply to those entities even after its period of application for schemes entered into during the period of application.

9. However, the Product Ruling only applies to the extent that:

- there is no change in the scheme or in the entity's involvement in the scheme;
- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

10. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

11. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

12. If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

## **Changes in the law**

13. Although this Product Ruling deals with the laws enacted at the time it was issued, later amendments may impact on this Product Ruling. Any such changes will take precedence over the application of this Product Ruling and, to that extent, this Product Ruling will have no effect.

14. Entities who are considering participating in the scheme are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

## **Note to promoters and advisers**

15. Product Rulings were introduced for the purpose of providing certainty about tax consequences for entities in schemes such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling is issued.

## **Previous Ruling**

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16. This Product Ruling replaces Product Ruling PR 2007/59 Income tax: deductibility of interest incurred on borrowings under the Leveraged Equities Share Protection Plan, which is withdrawn on and from 19 December 2007 due to changes made to the latter's scheme (initial scheme). PR 2007/59 will continue to apply to those investors who entered into the initial scheme before its withdrawal.

## Ruling

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17. Subject to paragraphs 2 and 20 of this Ruling:
- (a) the SPP interest amount reduced by an amount reasonably attributable to the cost of capital protection (Put Option Premium) under step 3 of the method statement in subsection 247-20(3) of the *Income Tax Assessment Act 1997* (ITAA 1997) or subsection 247-75(1) of the *Income Tax (Transitional Provisions) Act 1997* (IT(TP)A 1997), as applicable, will be deductible under section 8-1 of the ITAA 1997;
  - (b) where the Investor enters into the SPP on or after 19 December 2007 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008, under subsection 247-75(1) of the IT(TP)A 1997 the amount reasonably attributable to the Put Option Premium under Division 247 of the IT(TP)A 1997 in an income year is the amount by which the SPP interest amount exceeds the loan amount multiplied by the Reserve Bank of Australia's Indicator Rate for Personal Unsecured Loans – Variable Rate (the 'personal unsecured loan rate') at the time the first of the SPP interest amount is paid during the term of the loan (subsection 247-75(2) of the IT(TP)A 1997);
  - (ba) where the Investor enters into the SPP after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 and on or before 30 June 2010, under subsection 247-20(3) of the ITAA 1997 the amount reasonably attributable to Put Option Premium under Division 247 of the ITAA 1997 in an income year is the amount by which the SPP interest amount exceeds the loan amount multiplied by the sum of the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Housing Loans and 100 basis points (the 'adjusted loan rate') at the time the first of the SPP interest amount is paid during the term of the loan (subsections 247-20(4) and (5) of the ITAA 1997);
  - (c) section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny an Investor a deduction for the SPP interest amount allowable under section 8-1 of the ITAA 1997;
  - (d) section 82KL of the ITAA 1936 will not apply to deny deductibility of the SPP interest amount allowable under section 8-1 of the ITAA 1997;
  - (e) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the prepaid SPP interest amount allowable under section 8-1 of the ITAA 1997;

- (f) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of the prepaid SPP interest amount 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 a small business entity as defined in subsection 328-110(1) of the ITAA 1997; or
  - (ii) the Investor is an individual taxpayer who does not incur the interest charges in carrying on a business,
- (g) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for prepaid SPP interest amount that is deductible to an Investor (other than a small business entity for the year of income) who is a taxpayer that is not an individual and does not carry on a business;
- (h) the Put Option Premium will be included in the first element of the cost base and the reduced cost base of the Put Option under subsections 110-25(2) and 110-55(2) of the ITAA 1997;
- (i) if the Put Option is exercised, the Put Option Premium will be included in the second element of the cost base and reduced cost base of the Securities under item 2 in subsection 134-1(1) of the ITAA 1997. Any gain or loss on exercise of the Put Option will be disregarded by virtue of subsection 134-1(4) of the ITAA 1997;
- (j) if the Put Option is not exercised and it expires, a CGT event C2 will happen under paragraph 104-25(1)(c) of the ITAA 1997. The Investor will make a capital loss equal to the reduced cost base of the Put Option under subsection 104-25(3) 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 SPP interest incurred by the Investor in respect of borrowings used to fund the purchase of Securities.

## Scheme

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

- application for a Product Ruling dated 11 April 2007;
- documents relating to the SPP terms and conditions consisting of:
  - (a) Marketing brochure;

- (b) Application form (including Power of Attorney);
  - (c) SPP Agreement;
  - (d) SPP Notice (also referred to as SPP Confirmation) (dated 13 April 2007);
  - (e) Amended list of indicative interest rates (effective 25 October 2007);
  - (f) Nominee and Sponsorship Agreement; and
  - (g) Equitable Mortgage Agreement,
- additional information received 7 May 2007;
  - additional information received on 20 November 2007 regarding Addendum to the SPP Agreement; and
  - additional information received on 3 December 2007.

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

- (a) the SPP involves the granting of a put option (Put Option) and the making of a limited recourse loan to an Investor to finance 100% of the purchase of shares and/or units (Securities) in the Investor's name;
- (b) the Investor may choose a fixed loan term of one to five years;
- (c) the minimum loan amount is \$50,000 for a single Security and \$100,000 for multiple Securities;
- (d) the Securities are selected by an Investor from a list of companies and unit trusts listed on the Australian Securities Exchange (ASX) as specified by LEL;
- (e) the purchase price of each Security becomes the 'Protected Price', that is, the price to be received on exercise of the Put Option;
- (f) the Securities and the Protected Price are set out in the SPP Notice;
- (g) the rate of interest charged is fixed for the term of the SPP, and is payable annually in advance or monthly in arrears at the option of the Investor. Interest accrues daily, based on a full year;
- (h) the interest rate charged by LEL under the SPP varies from Security to Security and according to the term of the SPP. The longer the term, the cheaper the overall interest rate;
- (i) under the SPP, Investors are protected from a fall in the market value of the Securities by an LEL entity, Pirie Street Custodian Limited (Nominees), acquiring a Put Option(s) on behalf of the Investor. The Put Option is purchased from an unrelated third party under a

Power of Attorney granted to Nominees by the Investor. The rights under the Put Option are not transferable and not assignable without the written consent of LEL;

- (j) a portion of the interest payable under the SPP is referable to the Put Option Premium. This is the amount as calculated in paragraph 17(b) or 17(ba) of this Ruling. The Put Option Premium varies depending on the Securities selected, the market at the time and the term of the loan;
- (k) the Investor grants a mortgage to LEL over the Securities;
- (l) the SPP arrangement provides that in the event of default by the Investor or guarantor, LEL's entitlement to exercise its rights as mortgagee is limited to the proceeds on the sale of the Security;
- (m) if, at expiry of the loan, the market value of a particular tranche of Securities is less than the Protected Price, the Investor can instruct Nominees to exercise the Put Option and sell the Securities under the Power of Attorney. The exercise of the Put Option will result in the Securities realising a net sale price equal to the Protected Price;
- (n) seven working days before expiry of the SPP, Investors must notify LEL which of the following options they elect for the Securities:
  - repay the entire loan amount using their own funds and retain title to the Securities;
  - sell the Securities via their usual broker prior to close of business on the third working day before the expiry date, as long as the net sales price realised is more than the Protected Price and the contract note is received by LEL prior to the expiry date;
  - request LEL to enter into a new SPP with respect to that Security;
  - convert that part of the loan outstanding under the SPP to a standard Leveraged Equities Margin Lending Facility; or
  - where the market value of a particular tranche of Securities is less than the Protected Price relating to that tranche at the expiry date, instruct Nominees to exercise the Put Option and sell the Securities under the Power of Attorney. The exercise of the Put Option will

result in the Securities realising a net sale price equal to the Protected Price, and

- (o) any dividends or trust distributions paid in respect of the Securities are paid to the Investor.

### **Assumptions**

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

- (a) the Investors are Australian residents for taxation purposes;
- (b) the Investors are not traders in investments and would not be treated for taxation purposes as either trading in Securities or carrying on a business of investing in Securities. Further, the Investors do not otherwise hold the Securities as revenue assets;
- (c) any interest that is prepaid by Investors is paid up to a maximum period of 12 months 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 the arrangement is to derive assessable income comprising of dividends or trust distributions and capital gains from their investment in the Securities;
- (e) the Investors will not prepay the loan prior to maturity or terminate the arrangement early;
- (f) at all times during the arrangement, where the Securities include units in a unit trust, the trust satisfies the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- (g) all dealings by the Investors and LEL will be at arm's length; and
- (h) the scheme ruled on will be executed in the manner described in the Scheme section of this Ruling.

## Appendix 1 – Explanation

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**❶** *This Appendix is provided as information to help you understand how the Commissioner's view has been reached. It does not form part of the binding public ruling.*

### Section 8-1 and Division 247

21. Interest paid on a borrowing used to acquire income producing assets such as shares or units in a unit trust is generally treated as deductible under section 8-1 of the ITAA 1997 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

22. Division 247 of the ITAA 1997 applies to the SPP arrangement as a capital protected borrowing (CPB) because the Investor uses the loan to acquire Securities comprising of shares or units in a unit trust and the Investor is protected against the fall in the market value of the Securities.

23. Division 247 of the IT(TP)A 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a CPB entered into on or after 19 December 2007 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 (section 247-75). Division 247 of the IT(TP)A 1997 ignores any amount which is not in substance for capital protection or interest, in calculating the cost of capital protection (subsection 247-75(1)).

24. 23A. Division 247 of the ITAA 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a CPB entered into after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 (section 247-20). Division 247 of the ITAA 1997 ignores any amount which is not in substance for capital protection or interest, in calculating the cost of capital protection (subsection 247-20(3)). Under the SPP, the amount reasonably attributable to the cost of capital protection, being the Put Option Premium, is worked out under the method statement in subsection 247-75(1) of the IT(TP)A 1997 or subsection 247-20(3) of the ITAA 1997, as applicable and as set out in paragraphs 17(b) and 17(ba) respectively.

25. For an Investor in the SPP, the Investor's Put Option is a capital asset. As the Put Option Premium is the cost of the Investor's Put Option, this expense is capital in nature. The interest amount will be deductible under section 8-1 of the ITAA 1997 only to the extent that it is not the Put Option Premium.

### Section 51AAA

26. By entering into the SPP it is contemplated that an Investor will derive assessable income by the receipt of dividends or trust distributions and capital gains. As the interest allowable under

section 8-1 of the ITAA 1997 would have been deductible notwithstanding the inclusion of a net capital gain in assessable income, section 51AAA of the ITAA 1936 has no application to an Investor in the SPP.

### **Section 82KL**

27. The operation of section 82KL of the ITAA 1936 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 of the ITAA 1936. 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**

28. Subdivision H of Division 3 of Part III of the ITAA 1936 (Subdivision H) 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 small business entity, 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 to include amounts of less than \$1,000, or amounts of expenditure that are of a capital nature.

### ***Subdivision 328-C – small business entities***

29. An Investor will be a small business entity for an income year if the Investor carries on a business and either:

- the Investor carried on a business in the previous income year and the Investor's aggregated turnover for the previous year was less than \$2 million;
- the Investor's aggregated turnover in the current income year is likely to be less than \$2 million.

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

30. The SPP interest amount allowable under section 8-1 of the ITAA 1997, if prepaid, is in relation to a prepayment of loan interest for a period that is 12 months or less. 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 of the ITAA 1936, 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: prepaid expenditure and 'tax shelter' arrangements***

31. The rules in sections 82KZME and 82KZMF of the ITAA 1936 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.

32. For the purposes of section 82KZME of the ITAA 1936, '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 SPP, including the financing, purchase, holding and disposal of the SPP Securities.

33. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the interest amount allowable under section 8-1 of the ITAA 1997 incurred on borrowings under the SPP from the operation of section 82KZMF of the ITAA 1936, as:

- (a) the prepaid interest expenditure allowable under section 8-1 of the ITAA 1997 for the SPP is incurred in respect of money borrowed to acquire Securities that are listed for quotation on the ASX or units in a unit trust as described in subparagraphs 82KZME(5)(b)(ii) and (iii) of the ITAA 1936;
- (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 SPP are at arm's length.

Deductibility of the prepaid interest must therefore be considered under the prepayment rules outlined in paragraphs 34 to 39 of this Ruling.

***Section 82KZM: prepaid expenditure incurred by small business entities and individuals incurring non-business expenditure***

34. Section 82KZM of the ITAA 1936 operates to spread over more than one income year a deduction for prepaid expenditure incurred by a taxpayer that is either:

- (a) a small business entity for the year of income; or

- (b) an individual and the expenditure is not incurred in carrying on a business.

35. The expenditure must not be excluded expenditure and must be incurred otherwise than in carrying on a business. Section 82KZM of the ITAA 1936 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 less 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.

36. As the eligible service period in relation to the prepaid deductible interest under the SPP 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 of the ITAA 1936 will have no application to Investors who are small business entities 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 prepaid interest amount allowable under section 8-1 of the ITAA 1997 incurred under the SPP.

***Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by non-individual and non-small business entities***

37. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for an Investor (other than a small business entity for the year of income) who is an Investor that is not an individual and does not incur the expenditure in carrying on a business.

38. 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.

39. For these taxpayers, the amount of prepaid interest allowable as a deduction under section 8-1 of the ITAA 1997 incurred on the SPP will be apportioned over the relevant interest payment period.

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

40. That amount which is not deductible to the Investor under section 8-1 of the ITAA 1997 forms the first element of the cost base and reduced cost base of the Put Option pursuant to subsections 110-25(2) and 110-55(2) of the ITAA 1997 and constitutes an asset for capital gains tax purposes which is separate and in addition to the other rights created under the SPP as described in this Ruling.

41. If the Put Option is not exercised, the Investor will make a capital loss, at the time the Put Option expires, equal to the reduced

cost base of the Put Option (CGT event C2, paragraph 104-25(1)(c) of the ITAA 1997).

42. If the Put Option is exercised and title to the Securities is transferred to LEL, any gain or loss on exercise of the Put Option is disregarded by virtue of subsection 134-1(4) of the ITAA 1997. The Investor will include the Put Option Premium in the cost base and reduced cost base of the Securities (item 2 of the table in subsection 134-1(1) of the ITAA 1997) for the purpose of working out any capital gain or capital loss under CGT event A1.

## **Part IVA**

43. Provided that the SPP arrangement ruled on is entered into and carried out as disclosed in this Ruling, it is accepted that the arrangement is a normal commercial transaction and Part IVA of the ITAA 1936 will not apply.

**Appendix 2 – Detailed contents list**

44. The following is a detailed contents list for this Ruling:

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## References

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*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

TR 95/33

*Previous Rulings/Determinations:*

PR 2007/59

*Subject references:*

- debt deductions
- capital protected borrowing
- interest expenses
- prepaid expenses
- product rulings

*Legislative references:*

- ITAA 1936 51AAA
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KL
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZL(2)(a)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMD
- ITAA 1936 82KZME
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- ITAA 1936 82KZME(5)(b)(ii)
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- ITAA 1936 Pt IVA
- ITAA 1997 8-1
- ITAA 1997 104-25(1)(c)
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- ITAA 1997 110-55(2)
- ITAA 1997 134-1(1)
- ITAA 1997 134-1(4)
- ITAA 1997 Div 247
- ITAA 1997 247-20
- ITAA 1997 247-20(3)
- ITAA 1997 247-20(4)
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- IT(TP)A 1997 Div 247
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- TAA 1953
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ATO references

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