



PR 2007/67 - Income tax: tax consequences of investing in the Commonwealth Bank Protected Portfolio Loan

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 This document has changed over time. This is a consolidated version of the ruling which was published on 2 November 2011



Product Ruling

Income tax: tax consequences of investing in the Commonwealth Bank Protected Portfolio Loan

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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

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

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

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling part apply to the defined class of entities, who participate in the scheme to which this Product Ruling relates.
2. In this Product Ruling this scheme is referred to as the Commonwealth Bank Protected Portfolio Loan (PPL) offered by the Commonwealth Bank of Australia (the 'Bank').
3. This Ruling does not address the tax consequences of:
 - a loan advanced against an existing portfolio of shares;
 - extending the term of the PPL from the original maturity date or rolling-over the PPL into another form of financing;
 - the Protection Reset feature;
 - using the Portfolio Management feature of the PPL;
 - the Covered Calls feature; and
 - the early repayment and termination of the PPL,

which are available under the terms of the PPL, and described in the draft Product Disclosure Statement dated 1 July 2007.

Class of entities

4. The class of entities who can rely on this Product Ruling consists of those entities that are accepted to participate in the scheme specified at paragraphs 21 and 22 of this Ruling on or after 1 July 2007 and on or before 30 June 2008. 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 'Investor/s'.

Superannuation Industry (Supervision) Act 1993

5. 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

6. The class of entities defined in this Product Ruling may rely on it provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 18 to 22 of this Ruling.

7. 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

9. This Product Ruling applies prospectively from 1 July 2007. It therefore applies to the specified class of entities that enter into the scheme from 1 July 2007 until 30 June 2008, 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.

10. 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.

11. 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)).

12. 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.

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).

Previous Ruling

13. This Product Ruling replaces Product Ruling PR 2005/78 which is withdrawn on and from 30 June 2007 due to a change in the law which provides for a different tax treatment for investors who enter the arrangement on or after 1 July 2007. PR 2005/78 will continue to apply to investors who entered into the arrangement on or before 30 June 2007.

Changes in the law

14. 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 the Ruling and, to that extent, this Product Ruling will have no effect.

15. 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

16. 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.

Ruling

17. Subject to paragraph 3 and the assumptions in paragraph 23 of this Ruling:

- (a) The PPL interest charge reduced by an amount reasonably attributable to the cost of capital protection worked out 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.
- (i) Where the Investor enters into the PPL on or after 1 July 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 cost of capital protection under Division 247 of the IT(TP)A 1997 in an income year is the amount by which the PPL interest charge exceeds:
 - where interest is charged on the PPL from the Bank at a fixed rate for all or part of the term of the PPL and that fixed rate is applicable to the PPL for all or part of the income year, the amount of the PPL multiplied by the Reserve Bank of Australia's Indicator Rate for Personal Unsecured Loans – Variable Rate (the 'personal unsecured loan rate') at the time when the PPL interest charge is first incurred during the term of the PPL, or the relevant part of the term (subsection 247-75(2) of the IT(TP)A 1997); and
 - where interest is charged on the PPL from the Bank at a variable rate for all or part of the term of the PPL and a variable rate is applicable to the PPL for all or part of the income year, the amount of the PPL multiplied by the average of the personal unsecured loan rates published by the Reserve Bank of Australia during the term of the PPL, or the relevant part of the term (subsection 247-75(3) of the IT(TP)A 1997).
- (ii) Where the Investor enters into the PPL after 7.30 pm by legal time in the Australian Capital

Territory on 13 May 2008 and on or before 30 June 2008, under subsection 247-20(3) of the ITAA 1997, the amount reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997 in an income year is the amount by which the PPL interest charge exceeds:

- where interest is charged on the PPL from the Bank at a fixed rate for all or part of the term of the PPL and that fixed rate is applicable to the PPL for all or part of the income year, the amount of the PPL 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 rates') at the time when the PPL interest charge is first incurred during the term of the PPL, or the relevant part of the term (subsections 247-20(4) and (5)); and
- where interest is charged on the PPL from the Bank at a variable rate for all or part of the term of the PPL and a variable rate is applicable to the PPL for all or part of the income year, the amount of the PPL multiplied by the average of the adjusted loan rates published by the Reserve Bank of Australia during those parts of the income year when the PPL is at a variable rate (subsection 247-20(5) and (5A)).

- (b) The amount reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997, as worked out under paragraph 17(a) of this Ruling, is treated as the cost of the Put Option under subsection 247-20(6) of the ITAA 1997, and becomes part of the cost base of the Put Option under subsection 110-25(2) of the ITAA 1997. This amount is not deductible under section 8-1 of the ITAA 1997.
- (c) Section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny the deductibility of the interest charge under the PPL allowable under section 8-1 of the ITAA 1997.
- (d) Section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest charge under the PPL 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 interest charge under the PPL 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 interest charge under the PPL allowable under section 8-1 of the ITAA 1997, where at least one of the following applies for the year of income:
 - the Investor is an STS taxpayer; or
 - the Investor is an individual who does not incur the interest charge in carrying on a business.
- (g) Section 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for the interest charge under the PPL that is deductible to an Investor (other than an STS taxpayer for the year of income) who is a taxpayer that is not an individual and does not carry on a business.
- (h) If the Investor exercises the Put Option at the end of the PPL term, the cost of acquiring the Put Option will be added to the cost base of the Securities under section 134-1 of the ITAA 1997. Any gain or loss on exercise of the Put Option will be disregarded.
- (i) If the Investor does not exercise the Put Option at the end of the PPL term, CGT event C2 will happen pursuant to section 104-25 of the ITAA 1997 and the Investor will make a capital loss equal to the reduced cost base of the Put Option.
- (j) The grant of the Call Option by the Investor to the Bank under the Reduced Interest Rate feature is a CGT event which does not result in a capital gain or a capital loss.
- (k) If the Bank exercises the Call Option granted under the Reduced Interest Rate feature and the Investor transfers Securities to it, CGT event A1 will happen pursuant to section 104-10 of the ITAA 1997 and the Investor will make a capital gain equal to the capital proceeds received from the Bank less the Investor's cost base in the Securities. The proceeds received by the Investor from the Bank will be the Call Option Price.
- (l) If the Investor repays the PPL and sells Securities to fund the repayment, the Investor will make a capital gain on selling the Securities equal to the sale proceeds less the cost base of the Securities.

- (m) If, at the Final Maturity Date, the Investor repays the PPL but retains the ownership of the Securities, the payment to the Bank of the difference between the Market Value of the Securities and the Call Option Price will form part of the cost base of the Securities.
- (n) 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 the PPL used to fund the purchase of Securities.

Scheme

18. The scheme that is the subject of this Product Ruling is described below. The scheme is incorporated within the following documents:

- Application for a replacement Product Ruling dated 29 May 2007 received from Greenwoods & Freehills Pty Limited on behalf of the Bank; and
- Draft Product Disclosure Statement (PDS) dated 1 July 2007 and received 13 June 2007.

Note: certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

19. The documents highlighted are those that an Investor may enter into. For the purposes of describing the scheme to which this Product Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which an Investor or any associate of an Investor, will be a party to, which are a part of the scheme.

20. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of these agreements is summarised as follows.

Overview

21. Unless otherwise defined, capitalised terms in this Product Ruling have the same meaning as in the PDS.

22. Following is a summary of the scheme.

- (a) The PPL is a combination of a loan and Put Option. The limited recourse loan from the Bank is used by the Investor to finance 100% of the purchase price of a portfolio of shares and/or units listed on the ASX (Approved Securities) plus the applicable Brokerage. Where the Approved Securities include a stapled security, the stapled security comprises share/s and unit/s that are jointly listed for quotation on the ASX.

- (b) The Investor selects from a range of Approved Securities that the Bank has approved for inclusion in the PPL (Securities). The Investor grants a mortgage to the Bank over the Securities as security for the PPL.
- (c) The minimum loan amount is \$50,000.00. The minimum amount for an individual Security is \$10,000.00.
- (d) Investors can choose from fixed terms of 1, 2, 3, 4 or 5 years only.
- (e) The Interest Rate on the PPL is determined by the Bank taking into account a number of factors which are set out in the PDS. A different Interest Rate will generally apply for each Parcel of Securities. Where the Investor selects more than one Parcel of Securities, the Interest Rate will be the single weighted average Interest Rate that takes into account all of the Parcels of Securities selected.
- (f) Interest Payments on the PPL are payable by the Investor at either:
- a Fixed Interest Rate – annually in advance;
 - a Fixed Interest Rate – monthly in arrears; or
 - a Variable Interest Rate – monthly in arrears.
- (g) Subject to certain conditions, including the Bank's agreement, an Investor may elect to change their Interest Payment method from:
- a Variable Interest Rate (monthly in arrears) to a Fixed Interest Rate (annually in advance or monthly in arrears); and
 - vice versa.
- If an Investor elects to change their Interest Payment method from a Fixed Interest Rate paid annually in advance to monthly in arrears, or change to a Variable Interest Rate, this election can only be made at the end of the period that is the subject of the Fixed Interest Rate.
- (h) Under the PPL, the Bank also grants to the Investor a Put Option giving the Investor the right to transfer a purchased Parcel of Securities to the Bank for the option price equal to the principal outstanding under the loan in respect of those Securities (Protected Price). Unless instructed otherwise, the Bank is authorised by the Investor to exercise the Put Option if on the Final Maturity Date the Market Value of any of the Parcel of Securities is below their Protected Price.

- (i) A portion of the Interest Payments under the PPL is attributable to the Put Option premium. This is the amount addressed in paragraphs 17(a) and 17(b) of this Ruling.
- (j) The PPL is a limited recourse loan. As such, where the Investor fails to repay the PPL on the Final Maturity Date the Bank is only entitled to recover what is owing by selling the Securities sold to it under the Put Option or enforcing its rights as mortgagee against the Securities held as security.
- (k) The PPL also contains a Reduced Interest Rate feature. This feature allows an Investor to obtain a reduced rate of interest by agreeing to limit their entitlement to the capital growth of their Securities. Under the Reduced Interest Rate feature:
 - (i) the Investor grants the Bank a Call Option to purchase the Parcel of Securities at the Call Option Price at the Final Maturity Date of the PPL. The Call Option must have the same maturity date as the PPL;
 - (ii) the Call Option Price is calculated according to the amount of capital growth the Investor agrees to forgo by choosing the relevant Capped Rate and Participation Rate;
 - (iii) the Participation Rate allows the Investor to forgo some or all of the capital growth of the Parcel of Securities above the Capped Price. The Participation Rate will determine the percentage that the Investor will receive from any capital growth of the Parcel of Securities above the Capped Price. The Capped Price must be set above the Protected Price of the Securities and is determined by multiplying the Capped Rate (being a percentage greater than 100%) by the Protected Price of the Securities. The same Capped Rate and the Participation Rate must be applied to each Parcel of Securities under the PPL;
 - (iv) Investors must choose at the time of entering into the PPL whether or not they will utilise the Reduced Interest Rate feature;
 - (v) granting of the Call Option will result in the Investor being charged a lesser Interest Rate with regard to the PPL than would have been applicable if the Reduced Interest Rate feature had not been used. The reduction in the Interest Rate will depend on the Capped Rate and Participation Rate chosen;

- (vi) if the Bank exercises the Call Option at the Final Maturity Date of the PPL, the Investor must transfer the relevant Parcel of Securities to the Bank;
 - (vii) an Investor may also choose to cash settle the Call Option at the Final Maturity Date of the PPL in the event where a Call Option is exercised by the Bank. This results in a release of mortgage over the Parcel of Securities provided that the Investor pays the following to the Bank in full:
 - (A) the PPL; and
 - (B) an amount equal to the difference between the Call Option Price and the Market Value of the Parcel of Securities; and
 - (viii) the Bank will only exercise the Call Option at the Final Maturity Date of the PPL if the Market Value of the Parcel of Securities is equal to or above the Capped Price. Where the Market Value of the Parcel of Securities is less than the Capped Price, the Bank will not exercise the Call Option on the Final Maturity Date.
- (I) On the Final Maturity Date, the Investor shall settle the PPL. If the Investor has utilised the Reduced Interest Rate feature and the Call Option is exercised, the following alternatives are available:
- (i) sell all or some of the Securities to the Bank at the Call Option Price. The Bank will apply these proceeds on the Investor's behalf to repay their PPL and any surplus will be forwarded to the Investor;
 - (ii) use their own funds to repay the PPL and keep the relevant Securities. The Investor must pay the Bank the difference between the Call Option Price and the Market Value of the Parcel of Securities;
 - (iii) extend the Term of the PPL by applying for a new loan (subject to availability and credit approval). The Investor will need to pay the Bank the difference between the Call Option Price and the Market Value of the Parcel of Securities; or
 - (iv) a combination of the above.

- (m) Alternatively, if the Investor has not utilised the Reduced Interest Rate feature, the Investor has to inform the Bank at least five Business Days prior to the Final Maturity Date of the PPL how they wish to settle the PPL. The following alternatives are available:
- (i) sell all or some of the Securities. The sale proceeds will be used to repay all or some of the PPL and any surplus will be forwarded to the Investor. This will involve the Investor exercising the Put Option if any of the Securities are below the Protected Price;
 - (ii) use their own funds to repay the PPL and keep the relevant Securities;
 - (iii) extend the Term of a PPL by applying for a new loan (subject to availability and credit approval); or
 - (iv) a combination of the above.

The above alternatives are also available for Investors who utilised the Reduced Interest Rate feature whereby the Call Option is not exercised.

- (n) Any ordinary Dividends paid in respect of the Securities purchased under the PPL are paid to the Investors.
- (o) Securities acquired as a result of participating in a Dividend Reinvestment Plan will be retained by the Investors at the Final Maturity Date of the PPL.
- (p) Investors would be required to pay any brokerage, taxes, costs, charges and commission (if any) in relation to the purchase and sale of Securities, and the preparation of PPL documentation, including any stamp duty and brokerage fees.

Assumptions

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

- (a) all of the Investors are Australian residents for taxation purposes;
- (b) the Investors are not traders in investments and are not treated for taxation purposes as trading in the Securities, carrying on a business of investing in the Securities, or holding the Securities as trading stock or as revenue assets;

- (c) in respect of any interest charges to be paid in advance under the PPL, these may be prepaid 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) at all times during an arrangement, where the Securities include units in a trust, the trust satisfies the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- (e) the dominant purpose of an Investor in entering the arrangement is to derive assessable income from their Securities acquired under the PPL, comprising dividends or trust distributions and capital gains;
- (f) the arrangement will be executed in the manner described in the 'Scheme' section of this Ruling; and
- (g) all dealings by the Investors and the Bank under the PPL will be at arm's length.

Commissioner of Taxation27 June 2007

Appendix 1 – Explanation

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: capital protected borrowings and deductibility of interest

24. The 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).

25. Division 247 of the ITAA 1997 applies to a PPL because it is a capital protected borrowing, as:

- the Investor uses the loan from the Bank to acquire a beneficial interest in a Parcel of Securities comprising a share, a unit in a unit trust or a stapled security; and
- the Investor is protected against the fall in market value of the Parcel of Securities.

26. 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 capital protected borrowing entered into on or after 1 July 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, pursuant to subsection 247-75(1) of the IT(TP)A 1997.

26A. Division 247 of the ITAA 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a capital protected borrowing 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, pursuant to subsection 247-20(3) of the ITAA 1997.

27. Where an Investor enters into a PPL on or after 1 July 2007 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008, the amount reasonably attributable to the cost of capital protection is worked out under the method statement in subsection 247-75(1) of the IT(TP)A 1997, as set out in paragraph 17(a)(i) of this Ruling.

27A. Where an Investor enters into a PPL after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 and on or before 30 June 2008, the amount reasonably attributable to the cost of capital protection is worked out under the method statement in subsection 247-20(3) of the ITAA 1997, as set out in paragraph 17(a)(ii) of this Ruling.

28. As there is no separate charge payable by an Investor in a PPL for the Put Option, the cost of capital protection is only that amount worked out under 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(a)(i) and 17(a)(ii) of this Ruling respectively.

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

Section 51AAA

30. Under the PPL it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income or trust income as well as by way of capital gain. As the interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a capital gain, section 51AAA of the ITAA 1936 has no application to an Investor in the PPL.

Section 82KL

31. 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

32. 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 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 to include amounts of less than \$1,000 or amounts that are of a capital nature.

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

33. 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.

34. 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

35. The interest charge under the PPL 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) 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 PPL.

Sections 82KZME and 82KZMF: prepaid expenditure and ‘tax shelter’ type arrangements

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

37. 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 PPL, including the financing, share and/or unit purchase, share and/or unit holding and disposal arrangements.

38. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the amount of interest allowable as a

deduction under section 8-1 of the ITAA 1997 on borrowings under the PPL from the operation of section 82KZMF of the ITAA 1936, as:

- the prepaid interest expenditure under the PPL is incurred in respect of money borrowed to acquire Securities that are listed for quotation on the ASX or units in a trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- the Investor can reasonably be expected to obtain dividends or trust 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 PPL are at arm's length.

Deductibility of the prepaid interest must therefore be considered under the prepayment rules contained in paragraphs 38 to 43 of this Ruling.

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

39. 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:

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

40. 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 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.

41. As the eligible service period in relation to the deductible interest payments for the PPL 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 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 amount allowable as a deduction under section 8-1 of the ITAA 1997 incurred on the PPL.

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

42. Section 82KZMD of the ITAA 1936 sets the amount and timing of deductions for expenditure for an Investor (other than an STS taxpayer for the year of income) that is not an individual and does not incur the expenditure in carrying on a business.

43. Section 82KZMA of the ITAA 1936 requires that 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.

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

Put Option and Cost Base

45. The cost of the capital protection is not deductible to the Investor under section 8-1 of the ITAA 1997 (refer to paragraphs 17(b) and 29 of this Ruling) and is included in the cost base of the Put Option acquired by the Investor pursuant to subsection 110-25(2) of the ITAA 1997. The Put Option constitutes an asset for CGT purposes and is separate and in addition to the other rights created under the PPL as described in this Ruling.

46. If the Investor exercises the Put Option at the end of the PPL term by transferring title to the Securities to the Bank in satisfaction of the PPL, 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 Securities disposed to the Bank (subsection 134-1(1), item 2 of the ITAA 1997).

47. If the Investor does not exercise the Put Option by the end of the PPL term, the Investor will make a capital loss at that time, equal to the reduced cost base of the Put Option (CGT Event C2, paragraph 104-25(1)(c) of the ITAA 1997).

Reduced Interest Rate – Call Option

48. Under the arrangement the Investor grants the Bank a Call Option which may be exercised when the PPL matures if the market price of the Securities is greater than the Capped Price. If the Call Option is exercised, the Investor is required to transfer the Securities to the Bank in consideration for the Call Option Price.

49. 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.

50. Before the Bank issues the Call Option Notice, the Investor can elect to either:

- (a) transfer ownership of the Securities to the Bank; or

- (b) cash settle the Call Option obligations.

51. Where the Investor chooses to transfer ownership of the Securities to the Bank, CGT event A1 will happen in relation to the disposal of the Securities. Where the capital proceeds of the disposal exceed the cost base of the Securities, the Investor will make a capital gain. The cost base for the Securities will include the purchase price.

52. The capital proceeds the Investor receives when they deliver their Securities will be the Call Option Price.

53. Alternatively, the Investor may choose to cash settle the Call Option and repay the PPL by:

- (a) selling the Securities themselves and using these funds to pay to the Bank the PPL and the difference between the Market Value of the Securities and the Call Option Price;
- (b) not selling the Securities but using their own funds to pay to the Bank the PPL and the difference between the Market Value of the Securities and the Call Option Price; or
- (c) borrowing further funds from the Bank or refinances to pay to the Bank the PPL and the difference between the Market Value of the Securities and the Call Option Price.

54. Any sale of the Securities by the Investor will be the disposal of a CGT asset. The Investor will make a capital gain if the proceeds from the disposal are more than the cost base of the Securities. They will make a capital loss if those proceeds are less than the reduced cost base of the Securities.

55. The Investor will be required to pay to the Bank the difference between the Market Value of the Securities and the Call Option Price. This payment is capital expenditure made to preserve the Investor's title to the Securities and it will form part of the Securities' cost base (subsection 110-25(6) of the ITAA 1997).

Part IVA

56. Provided that the scheme ruled on is entered into and carried out as disclosed (see the Scheme part of this Product Ruling), it is accepted that the scheme is an ordinary commercial transaction and Part IVA of the ITAA 1936 will not apply.

Appendix 2 – Detailed contents list

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 95/33

Previous Rulings/Determinations:

PR 2005/78

Subject references:

- debt deductions
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- STS taxpayer
- tax avoidance
- taxation administration

Legislative references:

- ITAA 1936 51AAA
- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL(1)
- ITAA 1936 82KZL(2)(a)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
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