



PR 2008/13 - Income tax: tax consequences of investing in Next Financial Instalments - Series NF 330

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 This document has changed over time. This is a consolidated version of the ruling which was published on *21 May 2008*



Product Ruling

Income tax: tax consequences of investing in Next Financial Instalments – Series NF 330

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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.

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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

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 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. All legislative references in this Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

2. Next Financial Instalments – Series NF 330 (Next Financial Instalments or Instalments) are an investment comprising the borrowing of moneys on limited recourse terms from Next Financial Limited (Next Financial):

- to fund the acquisition of shares that are listed for quotation on an approved stock exchange, units of a widely held unit trust, and/or stapled securities comprising of shares and units that are jointly listed for quotation on an approved stock exchange (Underlying Securities);
- for business or investment purposes where such borrowing is secured by the Underlying Securities; or
- to repay an outstanding loan from Next Financial, applied to acquire Underlying Securities under a prior series of instalments issued by Next Financial.

3. In this Product Ruling the scheme is an investment in Next Financial Instalments where the shares, units and/or stapled securities forming part of the Underlying Securities are listed for quotation on the Australian Securities Exchange (ASX).

4. The Ruling does not address:

- (a) an Investor's entitlement to franking credits;
- (b) the tax consequences of an investment in Next Financial Instalments where the Underlying Securities consist of securities listed for quotation on approved stock exchanges other than the ASX;
- (c) the tax consequences of selling Next Financial Instalments back to Next Financial;
- (d) the tax consequences of electing to have the Maturity Date extended by Next Financial;

- (e) the tax consequences of electing to roll the Next Financial Instalments into a new tranche of instalments issued by Next Financial; and
- (f) the tax consequences of accepting a margin loan from Next Financial to fund the Final Instalment Payment.

Class of entities

5. This part of the Product Ruling specifies which entities can rely on the tax benefits set out in the Ruling section of this Product Ruling and which entities cannot rely on those tax benefits. In this Product Ruling, those entities that can rely on the tax benefits set out in this Ruling are referred to as Investors.

6. The class of entities who can rely on those tax benefits consists of entities that are accepted to participate in the scheme specified below on or after the date this Product Ruling is made and on or before 30 June 2011. They must have a purpose of staying in the scheme until it is completed (that is, being a party to the relevant agreements mentioned in paragraph 21 of this Ruling until their term expires), and deriving assessable income from this involvement.

7. The class of entities who can rely on the tax benefits set out in the Ruling section of this Product Ruling does **not** include entities who:

- participate in the scheme through offers made other than through the Product Disclosure Statement;
- intend to terminate their involvement in the scheme prior to its completion, or who otherwise do not intend to derive assessable income from it;
- are accepted into this scheme before the date of this Ruling or after 30 June 2011; or
- are Securityholder or Rollover Applicants who apply less than 100 per cent of any Cashback Amount received to fund the acquisition of a further Next Financial Instalment.

Superannuation Industry (Supervision) Act 1993

8. 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

9. The class of entities defined in this Product Ruling may rely on its contents provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 21 to 26 of this Ruling.

10. 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

12. This Product Ruling applies prospectively from 13 February 2008, the date this Product Ruling is made. It therefore applies only to the specified class of entities that enter into the scheme from 13 February 2008 until 30 June 2011, 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.

13. However this 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.

14. 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)).

15. 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.

16. 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

17. 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.

18. 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

19. 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

20. Subject to paragraph 4 and the assumptions in paragraph 26 of this Ruling:

- (a) Each Interest Amount, reduced by the amount reasonably attributable to the cost of capital protection under step 3 of the method statement in subsection 247-20(3), will be deductible under section 8-1.
- (b) Under subsection 247-20(3), the amount reasonably attributable to the cost of capital protection under Division 247 in an income year is the amount by which the Interest Amount for that income year exceeds the Loan Amount multiplied by the Reserve Bank of Australia's Indicator Rate for Personal Unsecured Loans – Variable Rate (the benchmark rate):

- (i) in the case of Fixed Rate Instalments, at the time the First Instalment Payment is incurred; or
 - (ii) in the case of Variable Rate Instalments, at the time each relevant Instalment Payment is incurred during the Term.
- (c) The part of the Interest Amount that is reasonably attributable to the cost of capital protection under Division 247 will be treated as having been incurred for a 'notional' put option granted by Next Financial under the arrangement (subsection 247-20(6)).
- (d) Section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny an Investor a deduction for the portion of the Interest Amount that is deductible under section 8-1 of the ITAA 1997.
- (e) Section 82KL of the ITAA 1936 will not apply to deny an Investor a deduction for the portion of the Interest Amount that is deductible under section 8-1 of the ITAA 1997.
- (f) Section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the portion of the Interest Amount that is deductible under section 8-1 of the ITAA 1997 where the Interest Amount is incurred on borrowings applied to acquire Underlying Securities.
- (g) Section 82KZM of the ITAA 1936 will not apply to deny an Investor immediate deductibility for the portion of the prepaid Interest Amount deductible under section 8-1 of the ITAA 1997 where the eligible service period (that is, the Interest Period) is not more than 12 months and ends on or before the last day of the year of income after the one in which the expenditure was incurred where at least one of the following applies for the year of income:
 - (i) the Investor is a small business entity that has not chosen for section 82KZMD of the ITAA 1936 to apply; or
 - (ii) the Investor is an individual taxpayer who has not incurred the expenditure in carrying on a business.
- (h) Section 82KZM of the ITAA 1936 will apply to set the amount and timing of deductions for the portion of the prepaid Interest Amount deductible under section 8-1 of the ITAA 1997 where the Interest Period to which the prepayment relates ends after the last day of the year of income after the one in which the expenditure was incurred and where one of the following applies for the year of income:
 - (i) the Investor is a small business entity that has not chosen for section 82KZMD of the ITAA 1936 to apply; or

- (ii) the Investor is an individual taxpayer who has not incurred the expenditure in carrying on a business.

The deductible amount is calculated using the formula in subsection 82KZM(1) of the ITAA 1936.

- (i) Sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for the portion of the prepaid Interest Amount deductible under section 8-1 of the ITAA 1997 to an Investor (other than a small business entity that has not chosen for section 82KZMD of the ITAA 1936 to apply) who is a taxpayer that is not an individual and does not carry on a business. The deductible amount is calculated using the formula in subsection 82KZMD(2) of the ITAA 1936.
- (j) For capital gains tax (CGT) purposes, the date that a Cash Applicant, or a Securityholder or Rollover Applicant who receive and apply their Cashback Amount to fund the acquisition of a Next Financial Instalment, acquire the beneficial interest in the Underlying Securities under section 109-5 is the date the Underlying Securities are acquired by the Instalment Security Trustee on their behalf.
- (k) No CGT event will occur when the legal title to an Underlying Security is transferred by a Securityholder Applicant or Rollover Applicant to the Instalment Security Trustee, or by the Instalment Security Trustee to the Investor on completion of a Next Financial Instalment pursuant to subsection 104-10(7).
- (l) If the capital protection in respect of any portion of the Loan is invoked, the 'notional' put option referred to in paragraph 20(c) of this Ruling will be treated under subsection 247-30(1) as having been exercised. The cost base of the 'notional' put option (which will include the amount determined under paragraph 20(b) of this Ruling) will form part of the cost base or reduced cost base of the Investor's Underlying Securities disposed of as a result of the capital protection being invoked under section 134-1. The capital proceeds from disposal of the Underlying Securities will be equal to the Loan Amount. Any capital gain or capital loss arising as a result of the exercise of the 'notional' put option will be disregarded under subsection 134-1(4).

- (m) If the capital protection in respect of any portion of the Loan is not invoked, the 'notional' put option referred to in paragraph 20(c) of this Ruling will be treated under subsection 247-30(2) as having expired un-exercised. A CGT Event C2 will occur under section 104-25 at that time. The capital proceeds received on expiration of the 'notional' put option will be nil under section 116-20. Pursuant to section 110-55, the Investor will make a capital loss equal to the reduced cost base of the 'notional' put option which will include the amount determined under paragraph 20(b) of this Ruling.
- (n) Any capital gain realised by an Investor on sale of the Underlying Securities, received pursuant to completion of a Next Financial Instalment, or as a result of directing Next Financial to sell the Underlying Securities on the Investor's behalf, will be treated as a discount capital gain pursuant to section 115-5 where the Investor is an individual, a complying superannuation entity, or a trust and has held the Underlying Securities for at least 12 months.
- (o) Only the Investors in Next Financial Instalments (and not the Instalment Security Trustee) are assessable under section 97 of the ITAA 1936 on all of the income derived from the Underlying Securities while the Underlying Securities are the subject of the Separate Trust.
- (p) Any Establishment Fee charged is deductible under section 25-25 over the shorter of 5 years and the period from drawdown of the Loan (the Drawdown Date) to Maturity.
- (q) The commercial debt forgiveness rules in Schedule 2C of the ITAA 1936 will not reduce the tax attributes of an Investor in relation to any debt forgiveness that arises because of the limited recourse nature of the Loan.
- (r) The anti-avoidance provisions in Part IVA of the ITAA 1936 will not apply to an Investor in respect of the Next Financial Instalments.

Scheme

21. The scheme that is the subject of this Ruling is identified and described in the following documents:

- Application for a Product Ruling dated 20 August 2007 and additional correspondence and emails dated 4 September 2007, 4 October 2007, 31 October 2007, 14 November 2007, 19 November 2007, 29 November 2007, 14 January 2008, 29 January 2008, 5 February 2008 and 6 February 2008;

- Product Disclosure Statement for the Next Financial Instalments, draft dated 17 August 2007 and 6 February 2008;
- Sample Rate Sheet, draft dated 17 August 2007;
- Sample Next Financial Instalment Confirmation letter (Confirmation), draft dated 17 August 2007;
- Next Financial Instalments Instalment Deed (the Instalment Deed) to be executed by Next Financial (as Issuer) and Next Financial Nominees Pty Ltd (as Instalment Security Trustee), draft dated 17 August 2007 and 6 February 2008;
- Next Financial Instalments Nominee Deed to be executed by Next Financial Nominees Pty Ltd (as Instalment Security Trustee), draft dated 17 August 2007; and
- Next Financial Instalments Loan Agreement (the Loan Agreement) to be executed by Next Financial (as Lender) and Next Financial Nominees Pty Ltd (as Instalment Security Trustee), draft dated 17 August 2007 and 6 February 2008.

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

22. 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.

23. In this Ruling, unless otherwise defined, capitalised terms take their meaning as per the documents listed in paragraph 21 of this Ruling.

24. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

25. Following is a summary of the scheme:

- (a) On acceptance of the Investor's application for a Next Financial Instalment, the Investor will obtain a limited recourse loan (the Loan) from Next Financial to purchase the Underlying Securities, via Next Financial Nominees Pty Ltd as the Instalment Security Trustee.

- (b) The Underlying Securities which are held for the Investor for a particular Next Financial Instalment will comprise a basket of securities selected by Next Financial, as identified in the Rate Sheet. Each of the Underlying Securities will be a 'security' or 'financial product' as defined in the *Corporations Act 2001* or their equivalent in any jurisdiction outside of Australia. This may include units in listed unit trusts having more than 300 unitholders and may in some circumstances include stapled securities. The Underlying Securities will not change throughout the life of the Instalment except in response to a corporate action.
- (c) The shares, units and/or stapled securities forming part of the Underlying Securities under a Next Financial Instalment will either be listed entirely for quotation on the ASX, or listed entirely for quotation on approved stock exchanges other than the ASX. This Ruling does not consider the tax consequences of an investment in Next Financial Instalments where the Underlying Securities consist of securities listed for quotation on approved stock exchanges other than the ASX.
- (d) The Next Financial Instalments will not be listed for quotation on the ASX, but Investors may transfer their Instalments by private treaty.
- (e) The minimum Subscription Amount, equal to the purchase price of the initial Underlying Securities, is \$100,000 (unless otherwise permitted).
- (f) The term of the Loan will be for a period of up to 10 years. Next Financial Instalments will be offered with gearing levels of up to, but not exceeding, 120 per cent of the value of the Underlying Securities. The amount of the Loan for each Instalment (the Loan Amount) will be fixed by Next Financial and identified in the relevant Confirmation. The Loan Amount will be allocated amongst the Underlying Securities in proportion to their purchase price (Allocated Loan Amount).
- (g) Repayment of the Loan Amount will be secured by a charge in favour of Next Financial granted under the Instalment Deed (the Security Interest) over the Underlying Securities for each Next Financial Instalment, held by the Instalment Security Trustee on trust for the Investor, as well as any amounts held by the Instalment Security Trustee in cash (the Secured Property). As Lender, Next Financial will be entitled to exercise its Security Interest in respect of some or all of the Secured Property in the case of any event of default by the Investor, such as a failure to pay Interest Amounts when due.

- (h) The Next Financial Instalment terms provide a capital protection feature pursuant to which Next Financial may purchase from the Investor any Underlying Securities having a market value net of Transaction Costs (Market Value) below the Allocated Loan Amount for those Underlying Securities for an amount equal to that Allocated Loan Amount. This feature may be invoked by Next Financial at any time that the Instalments are completed or closed out.
- (i) In addition, the Loan for each Next Financial Instalment will be provided on limited recourse terms on a 'partitioned' basis. That is, Next Financial's right as Lender to repayment of each Allocated Loan Amount will be limited to the amount which it can obtain by enforcing its rights in respect of the relevant Underlying Securities to which that portion is allocated. The Lender's recourse against an Investor for any other amounts (for example, unpaid Interest Amounts) owed to the Lender will also be limited to the Secured Property, but on a 'non-partitioned' basis.
- (j) The Investor will retain the beneficial interest in the Underlying Securities for each Next Financial Instalment throughout the term of the Instalment. However, the Underlying Securities will remain registered in the name of the Instalment Security Trustee (or other nominated custodian) until the Security Interest is released or discharged. Each parcel of Underlying Securities for an Instalment will be held under a Separate Trust and there will be no pooling of interests or property to which the trust relates.
- (k) During the term of the Loan, Next Financial may assign its rights under the Loan Agreement to a third party. Any such assignment may involve an assignment by Next Financial of its rights under the Security Interest, the grant of a new or additional security interest over the Underlying Securities to another lender, or the grant of a security interest over Next Financial's rights under the Security Interest granted by the Investor.
- (l) An Establishment Fee of up to 4.5 per cent of the Loan Amount may be payable to the Lender on application in consideration for the grant of the Loan for each Next Financial Instalment. The Establishment Fee relates to the cost to Next Financial in respect of offering, creating and administering the loan, and providing and maintaining the provision of the Loan Amount.
- (m) Interest is typically charged on the Loan Amount at a variable interest rate, but may also be charged at a rate fixed throughout the Term.

Interest on the Loan will be payable annually in advance (the Interest Amounts). The Interest Amount payable for each Interest Period, and the time at which such amount will be payable, will be specified in the Investor's Confirmation. Interest on the Loan will be applied to the Loan principal and will be equal to a specified amount for the first Interest Period and, for subsequent Interest Periods, will equal a benchmark rate plus a specified margin.

- (n) The Investor is required to pay the Interest Amount that relates to the first Interest Period from the Investor's own funds. On the Drawdown Date of the Loan for each Next Financial Instalment a portion of the Loan Amount will be applied to prepay part of the Interest Amount for each Interest Period subsequent to the first. The balance of the Interest Amount for each subsequent Interest Period will be paid by the Investor annually in advance from their own funds.
- (o) During the period of the Loan, Investors will be entitled to the benefit of all dividends and distributions paid on the Underlying Securities. These may be held by the Instalment Security Trustee in cash to be applied toward payment of future Interest Amounts. However, if agreed by Next Financial, Investors who hold a Variable Rate Instalment may elect to withdraw the dividend on a quarterly basis. This option is not available to Investors who hold a Fixed Rate Instalment. The Instalment Security Trustee will assist with voting in respect of the Underlying Securities as directed by the Investor, where it is reasonably practicable.
- (p) At the Maturity Date, or at any time prior to that date, Investors may 'complete' the Next Financial Instalment by:
 - (i) taking delivery of those Underlying Securities whose Market Value is above their Allocated Loan Amount by paying the Final Instalment Payment (that is, repaying the Loan Amount allocated to those Underlying Securities, as well as any other costs outstanding including Transaction Costs, outstanding Interest Amounts and any break costs (Early Completion Adjustment), if applicable). Each Underlying Security whose Allocated Loan Amount has been repaid will be transferred to the Investor free of any Security Interest once all other outstanding amounts have been paid. For the remaining Underlying Securities whose Market Value is below their Allocated Loan Amount, if any, the capital protection feature described in paragraph 25(h) of this Ruling is relied upon whereby Next Financial will purchase the Underlying Securities for an amount that repays that Allocated Loan Amount; or, alternatively

- (ii) instructing Next Financial to sell on market those Underlying Securities whose Market Value is equal to or above its Allocated Loan Amount and rely on the capital protection feature described in paragraph 25(h) of this Ruling for the remaining Underlying Securities, if any. The proceeds from the sale of all Underlying Securities will be used to repay the Loan Amount, any Transaction Costs, outstanding Interest Amounts and any Early Completion Adjustment, if applicable, with any excess being paid to the Investor.
- (q) An Early Completion Adjustment may apply where a Fixed Rate Instalment is completed prior to the Maturity Date.
- (r) In the absence of a valid Completion Notice on or before the Maturity Date instructing Next Financial of the Investor's decision to complete the Next Financial Instalment by way of either option set out in subparagraphs 25(p)(i) and 25(p)(ii) of this Ruling, Next Financial will close out the Instalment in a manner consistent with that set out in subparagraph 25(p)(ii).
- (s) Where the limited recourse feature of the Loan described in paragraph 25(i) of this Ruling is relied upon, Next Financial will exercise its power of sale under the Security Interest. The proceeds of sale will be applied in repayment of the Allocated Loan Amounts for the Underlying Securities disposed of, any costs incurred by the Lender or the Instalment Security Trustee in relation to the sale, and any other outstanding costs. Any remaining proceeds will be paid to the Investor. If the sale proceeds are insufficient to repay the Allocated Loan Amount or other outstanding amounts in full, the Investor will not be required to pay the shortfall.
- (t) Alternatively, an Investor may be able to extend the Maturity Date and term of the Loan and Next Financial Instalments by agreement with Next Financial, or roll the Instalments into a subsequent series of instalments issued by Next Financial over the same Underlying Securities. In the latter case, the Instalment Security Trustee will continue to hold the Underlying Securities on trust for the Investor, subject to the terms of the subsequent series of instalments.

This Ruling does not consider the tax consequences of extending the Maturity Date or rolling the Next Financial Instalments into a subsequent series of instalments issued by Next Financial.

- (u) Next Financial may also determine an early termination date at its discretion or an Early Maturity Date in certain limited circumstances. Capital protection through the limited recourse features of the Loan will generally continue to apply where there is an early termination date or Early Maturity Date.
- (v) There are three ways of investing in Next Financial Instalments. Other than by a Cash Application, Next Financial Instalments can be purchased either by a Securityholder Application or a Rollover Application.
- (w) A Securityholder Application is an application for Next Financial Instalments where the consideration for the issue of the Instalments is or includes, as agreed by Next Financial, the transfer of the Investor's existing holding of securities to the Instalment Security Trustee to form part of the Underlying Securities. A Securityholder Applicant may be required to make a smaller upfront cash contribution than a Cash Applicant, or no upfront cash contribution, and may in some circumstances receive a Cashback Amount upon acquiring Next Financial Instalments. Next Financial will not accept a Securityholder Application from an applicant that is a trustee of a complying superannuation fund.
- (x) Investors who hold existing instalments issued by Next Financial over particular Underlying Securities may make a Rollover Application for Next Financial Instalments over identical Underlying Securities. The Underlying Securities of the prior series instalment would continue to be held by the Instalment Security Trustee on trust for the Investor. A Rollover Applicant may in some circumstances receive a Cashback Amount or pay an upfront cash contribution upon acquiring Next Financial Instalments.
- (y) The Loan Agreement requires that any Cashback Amount received by either a Securityholder or Rollover Applicant must be used by the Investor for assessable income producing business or investment purposes. Investors cannot rely on this Product Ruling where they receive a Cashback Amount and do not apply that amount wholly towards the First Instalment Payment under a Cash Application for further Next Financial Instalments.

Assumptions

26. 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 Underlying Securities, carrying on a business of investing in the Underlying Securities, or holding the Underlying Securities as trading stock or as revenue assets;
- (c) the Investors' purpose in entering the scheme is to derive assessable income from their investment in the Next Financial Instalments;
- (d) neither Next Financial nor any related bodies corporate intend to invest in the Next Financial Instalments;
- (e) the scheme will be executed in the manner described in the Scheme section of this Ruling; and
- (f) all dealings by the Investors and Next Financial will be at arm's length.

Commissioner of Taxation13 February 2008

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: deductibility of interest

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

Division 247: capital protected borrowings

28. Division 247 applies to the arrangement as a capital protected borrowing (CPB) because the Investor uses the Loan to acquire a beneficial interest in shares, units or stapled securities, or uses such assets as security for the Loan, and the Investor is protected against the fall in the market value of the shares, units or stapled securities for the purposes of section 247-10.

29. Division 247 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a CPB (section 247-20). Division 247 ignores any amount which is not in substance for capital protection or interest, in calculating the cost of capital protection (subsection 247-20(3)).

30. Under the Next Financial Instalments, the amount reasonably attributable to the cost of capital protection is worked out under the method statement in subsection 247-20(3), as set out in paragraph 20(b) of this Ruling. This amount will be treated as an amount incurred by the Investor for a put option (the 'notional' put option) granted by Next Financial, as the Lender, under the arrangement (subsection 247-20(6)).

31. The Investor's 'notional' put option is a capital asset. As the cost of capital protection is the cost of the 'notional' put option, this expense will be capital in nature. The Interest Amount will be deductible under section 8-1 only to the extent that it is not the cost of capital protection.

Section 51AAA

32. An Investor is expected to derive assessable income over the period of their investment in the Next Financial Instalment by way of the receipt of dividend income and/or other distributions of income, and capital gains obtained on any sale of the Underlying Securities. As the Interest Amount will be deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a net capital gain in assessable income, section 51AAA of the ITAA 1936 has no application to an Investor acquiring Next Financial Instalments.

Section 82KL

33. 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. Section 82KL of the ITAA 1936 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

34. Subdivision H of Division 3 of Part III of the ITAA 1936 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 entity

35. An Investor will be a small business entity for an income year if the Investor carries on a business in that year and either the aggregated turnover for the year is, or is likely to be, less than \$2 million, or the aggregated turnover from a business carried on in the previous income year was less than \$2 million.

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

36. The Interest Amount that is an allowable deduction under section 8-1 of the ITAA 1997 is in relation to a prepayment of interest on the Loan. 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 Division 3 of Part III 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 interest is determined by reference to the period to which the interest relates, and not to the term of the loan (which may be up to 10 years in the case of the Loan).

Sections 82KZME and 82KZMF: prepaid expenditure and 'tax shelter' arrangements

37. 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.

38. 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) of the ITAA 1936, the relevant 'agreement' is all the contractual arrangements and activities associated with the participation in the Next Financial Instalments, including the financing, purchase, holding and disposal arrangements for the Underlying Securities.

39. Under the arrangement, when an Investor acquires a Next Financial Instalment, they acquire beneficial ownership of the shares, units or stapled securities comprising the Underlying Securities.

40. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the portion of the Interest Amount deductible under section 8-1 of the ITAA 1997 incurred on borrowings under the Next Financial Instalment from the operation of section 82KZMF of the ITAA 1936, as:

- (a) the prepaid interest expenditure under the Next Financial Instalment is incurred in respect of money borrowed to acquire shares that are listed for quotation on the ASX and/or units in a trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936 and/or stapled securities;
- (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 Instalment are conducted at arm's length.

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

41. 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 that has not chosen for section 82KZMD of the ITAA 1936 to apply; or

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

42. 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.

Prepayment of interest made at the commencement of annual Interest Periods

43. That part of the portion of the Interest Amount deductible under section 8-1 of the ITAA 1997 and prepaid from an Investor's own funds at the commencement of an annual Interest Period relates to an eligible service period that is not more than 12 months and which ends on or before the last day of the year of income after the one in which the expenditure was incurred. Therefore, section 82KZM of the ITAA 1936 will have no application to Investors who are small business entities for the year of income that have not chosen for section 82KZMD of the ITAA 1936 to apply, or to Investors who are individual taxpayers and the expenditure is not incurred in carrying on a business. Investors who satisfy these conditions will be able to claim an immediate deduction in respect of that portion of the Interest Amount.

Prepayment of interest made on the Drawdown Date

44. That part of the portion of the Interest Amount deductible under section 8-1 of the ITAA 1997 and prepaid on the Drawdown Date from a portion of the Loan Amount relates to subsequent annual Interest Periods and, when incurred by an Investor that is either a small business entity for the year of income that has not chosen for section 82KZMD of the ITAA 1936 to apply or an individual taxpayer not carrying on a business, will be apportioned over the eligible service period in accordance with section 82KZM of the ITAA 1936 as the eligible service period for this expenditure is longer than 12 months.

Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by taxpayers that are not individuals or small business entities

45. 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 that has not chosen for section 82KZMD to apply) who is a taxpayer that is not an individual and does not carry on a business.

46. 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.

47. For these Investors, the allowable deduction for the portion of the prepaid Interest Amount deductible under section 8-1 will be apportioned over the relevant Interest Period.

Section 109-5: time of acquisition of Underlying Securities

48. Section 109-5 applies to Investors to treat them as having acquired the Underlying Securities at the time the Investors obtained beneficial ownership of the Underlying Securities. This is the time that the Instalment Security Trustee acquires the Underlying Securities on the Investor's behalf, or, for Securityholder or Rollover Applicants, the time the Investor originally acquired beneficial ownership of the Underlying Securities.

Subsection 104-10(7): disposal of Underlying Securities

49. When the Investor completes the Next Financial Instalment, no CGT event will arise in respect of the transfer of the legal title to the Underlying Security from the Instalment Security Trustee to the Investor by virtue of subsection 104-10(7).

Section 110-25: cost base of 'notional' put option

50. The Interest Amount charged on the Loan that is reasonably attributable to the capital protection feature of the Loan (determined in accordance with paragraph 20(b) of this Ruling) forms part of the cost base and reduced cost base of a 'notional' put option (under subsections 110-25(2) and (4)) which constitutes an asset for capital gains tax purposes and is separate and in addition to the other rights created under the Next Financial Instalment.

Section 104-25: expiry of 'notional' put option

51. Where the Investor completes the Next Financial Instalment or the Instalment is otherwise closed out in respect of the Underlying Securities and the capital protection feature of the Loan is not invoked, the 'notional' put option will expire. The expiration of the 'notional' put option gives rise to CGT event C2 (paragraph 104-25(1)(c)). The capital proceeds received on the lapsing of the 'notional' put option will be nil and the Investor will make a capital loss equal to the reduced cost base in the 'notional' put option which, pursuant to section 110-55, will include the amount determined to be attributable to the capital protection feature under paragraph 20(b) of this Ruling.

Section 104-10: CGT event A1

52. Where the Investor chooses to sell their Underlying Securities to Next Financial for the Loan Amount allocated to them or they are sold by Next Financial on exercise of its power of sale under the Security Interest and not pursuing the Investor for the shortfall in repayment of the Loan Amount, CGT event A1 will arise for the Investor. In these circumstances the capital protection feature is invoked and the 'notional' put option will be taken to have been exercised. As a result of the capital protection feature being invoked, the cost base of the 'notional' put option, as worked out according to paragraph 20(b) of this Ruling, will be included in the cost base or reduced cost base of the Underlying Securities disposed of pursuant to section 134-1.

Section 115-5: discount capital gains

53. Division 115 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 Underlying Securities will be treated as a discount capital gain where the Investor is an individual, a complying superannuation entity, or a trust and has held a beneficial interest in the Underlying Security for at least 12 months (excluding the days of acquisition and disposal).

Section 97

54. The Investors are presently entitled to all of the income derived from the Underlying Securities. Therefore, section 97 of the ITAA 1936 will apply to assess the Investors on the income derived from the Underlying Securities.

Section 25-25: deductibility of Establishment Fee

55. No part of the Establishment Fee is attributable to interest or capital protection. The Establishment Fee is deductible in accordance with section 25-25 from the Drawdown Date of the Loan.

Schedule 2C: commercial debt forgiveness

56. Where the limited recourse feature of the Loan comes into effect, the Investor is not required to pay the Final Instalment Payment, and therefore there will be a commercial debt forgiveness under section 245-35 of Schedule 2C to the ITAA 1936. Under Schedule 2C where a forgiveness results in an investor having a positive 'net forgiven amount', the investor will be required to reduce certain tax attributes to the extent of the net forgiven amount.

57. To determine the net forgiven amount of a debt forgiveness it is first necessary to determine the 'gross forgiven amount'. In the Investor's circumstances Schedule 2C of the ITAA 1936 will have no practical effect as the gross forgiven amount in respect of the debt will be equal to zero. The gross forgiven amount is equal to the 'notional value' of the debt less any consideration paid or given in respect of the debt.

58. The notional value of the Final Instalment Payment debt is the *lesser* of the limited recourse debt outstanding at the time of the debt forgiveness and the market value of Next Financial's rights as Lender in relation to the Underlying Securities at the time of the debt forgiveness, under section 245-60 of Schedule 2C of the ITAA 1936. The situation where the limited recourse feature of the Instalments may come into effect is where the market value of the Underlying Securities will not cover the Final Instalment Payment. In such a situation the market value of Next Financial's rights in relation to the Underlying Securities will arguably be no more than the market value of the Underlying Securities at that point in time.

59. The consideration paid by an Investor in respect of the debt forgiveness would be equal to the market value of any property given by the Investor in respect of the debt forgiveness as determined at the time of the forgiveness, under paragraph 245-65(1)(b) of Schedule 2C of the ITAA 1936. Arguably, this market value is equal to the market value of the Next Financial's rights in relation to the Underlying Securities. Therefore the gross forgiven amount will be nil.

60. Accordingly, Schedule 2C of the ITAA 1936 will not reduce an Investor's tax attributes where the limited recourse feature of the Loan comes into effect.

Part IVA: anti-avoidance

61. Provided that the scheme ruled on is entered into and carried out as disclosed in this Ruling, it is accepted that the scheme is an ordinary commercial transaction and Part IVA of the ITAA 1936 will not apply.

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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 95/33

Subject references:

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

Legislative references:

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- ITAA 1936 82KL
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