



# ***PR 2010/13 - Income tax: deductibility of interest incurred on borrowings in relation to Macquarie Fusion Funds - June 2010 Offer***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *19 May 2010*



## Product Ruling

### Income tax: deductibility of interest incurred on borrowings in relation to Macquarie Fusion Funds – June 2010 Offer

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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, the Commissioner must apply the law to you in the way set out in the ruling (unless the Commissioner is satisfied that the ruling is incorrect and disadvantages you, in which case the law may be applied to you in a way that is more favourable for you – provided the Commissioner is 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 Commissioner **does not** sanction or guarantee this product. Further, the Commissioner gives 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. The Commissioner recommends 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

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) 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. In this Product Ruling the scheme is the investment in a Macquarie Fusion Fund using a full recourse loan (Investment Loan) made by Macquarie Bank Limited (the Bank) and the grant of a put option (Put Option) over the investment by the Bank; a further borrowing from the Bank, if it occurs, used to fund the payment of interest and payment for the cost of the Put Option (Interest and Put Protection Fee Loan). The Investment Loan and Interest and Put Protection Fee Loan are in the form of the Loan and Security Agreement contained in Appendix C of the Product Disclosure Statement (PDS) that forms part of the scheme.
3. This Ruling does not deal with the taxation consequences of:
  - fees paid by a Fusion Fund – Equity Trust or the Fusion Fund – Cash Trust;
  - fees paid to the Responsible Entity;
  - the 'Threshold Management' process (see paragraphs 23(i) to 23(n) of this Ruling); or
  - any upfront and trailing commissions, including any arrangement whereby commissions are rebated by a financial adviser to an Investor (see paragraphs 23(z) and 23(aa) of this Ruling).

### Class of entities

4. This part of the Product Ruling specifies which entities:
  - are subject to the taxation obligations; and
  - can rely on the taxation benefits,

set out in the Ruling section of this Product Ruling.

5. 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 the date this Product Ruling is published and which execute relevant Agreements mentioned in paragraph 20 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 Investor/s.

6. 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:

- terminate their involvement in the scheme prior to its completion, or who do not intend to derive assessable income from it;
- are accepted to participate in the scheme specified below and which execute relevant Agreements mentioned in paragraph 20 of this Ruling before this Ruling is published or after 30 June 2010; or
- are subject to Division 230 in respect of this scheme. Division 230 will generally not apply to individuals, unless they have made an election for it to apply to them.

### **Superannuation Industry (Supervision) Act 1993**

7. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA). The Commissioner gives no assurance that the scheme 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 scheme may contravene the provisions of SISA.

### **Qualifications**

8. 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 20 to 24 of this Ruling.

9. 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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11. This Product Ruling applies prospectively from 19 May 2010, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 19 May 2010 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 has ended for the scheme entered into during the period of application.

12. 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.

## Changes in the law

13. Although this Product Ruling deals with the income tax 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.

## ***Proposed amendments to Division 247***

15. On 11 May 2010, the Government released for consultation draft legislation that gives effect to announced changes to the benchmark interest rate in the capital protected borrowing rules referred to in paragraph 19(b) of this Ruling. These changes apply to capital protected borrowings entered into after 7:30pm (AEST) on 13 May 2008. If enacted, such changes will take precedence over the application of this Ruling and, to that extent, this Product Ruling will cease to have effect.

## ***Schedule 3 of Tax Laws Amendment (2010 Measures No. 1) Bill 2010***

16. Schedule 3 of the *Tax Laws Amendment (2010 Measures No. 1) Bill 2010* proposes to allow eligible Australian managed investment trusts to make an irrevocable election (that is, choice) to apply the capital gains tax provisions as the primary code for the taxation of gains and losses on disposal of certain assets held as passive investments (primarily shares, units and real property). This amendment has effect from the 2008-09 income year. If enacted, such changes will take precedence over the application of this Ruling and, to the extent (if any) that the changes are inconsistent with this Product Ruling, then this Product Ruling will cease to have effect.

17. As the proposed laws outlined in paragraphs 15 and 16 of this Ruling have not been enacted, the Commissioner cannot give a legally binding ruling on these changes until the relevant legislations are enacted. Once the changes are enacted, this Product Ruling will be reviewed to reflect the changes in the law.

#### **Note to promoters and advisers**

18. 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 Commissioner suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling has issued.

## **Ruling**

#### **Application of this Ruling**

19. Subject to paragraph 3 of this Ruling and the assumptions in paragraph 24 of this Ruling:

- (a) Division 247 will apply to the scheme to treat the excess (if any) calculated under the method statement in subsection 247-20(3) (the Excess Amount) as being reasonably attributable to the cost of capital protection for the income year;
- (b) under subsection 247-20(3), the Excess Amount in an income year is the amount by which the total of the Protection Fee and the interest incurred on the Investment Loan and (if applicable) the Interest and Put Protection Fee Loan for the income year (Total Amount) exceeds an amount representing the interest that would have been incurred for the income year on the Investment Loan and the Interest and Put Protection Fee Loan (if applicable) if the following interest rates applied:
  - where the interest rate incurred on a Loan is a fixed rate for all or part of the term of the loan, the relevant rate is the Reserve Bank of Australia's Indicator Rate for Personal Unsecured Loans – Variable Rate (benchmark rate) at the time when the first of the amounts included in the Total Amount is incurred during the term of the loan, or the relevant part of the term of the loan (subsection 247-20(4)); and

- where the interest rate incurred on a Loan is a variable rate for all or part of the income year, the relevant rate is the average of the benchmark rates published by the Reserve Bank of Australia during the income year, or relevant part of the income year (subsection 247-20(5));
- (c) any Excess Amount, as worked out under paragraph 19(b) of this Ruling, reduced by:
  - the Protection Fee, and
  - if applicable, the proportion of interest incurred on the Interest and Put Protection Fee Loan for the Put Protection Fee (Put Option Interest),is treated as a further cost of the Put Option (the Additional Amount) under subsection 247-20(6);
- (d) the Additional Amount (if any), the Protection Fee and the Put Option Interest are not deductible under section 8-1;
- (e) an amount equal to the interest incurred on the Investment Loan and interest incurred on the Interest and Put Protection Fee Loan (if applicable) reduced by:
  - the Additional Amount (if any), and
  - the Put Option Interest (if applicable),will be deductible under section 8-1;
- (f) section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny an Investor a deduction for the interest allowable under section 8-1 of the ITAA 1997;
- (g) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest allowable under section 8-1 of the ITAA 1997;
- (h) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the prepaid interest allowable under section 8-1 of the ITAA 1997 in respect of borrowings under an Investment Loan;
- (i) section 82KZM of the ITAA 1936 will not apply to deny an Investor immediate deductibility of the prepaid interest on an Investment Loan 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 a small business entity (as defined in subsection 328-110(1) of the ITAA 1997) that has not chosen to apply section 82KZMD of the ITAA 1936; or
  - the Investor is an individual who does not incur that expenditure in carrying on a business;

- (j) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for prepaid interest on borrowings under an Investment Loan that is allowable under section 8-1 of the ITAA 1997 to an Investor (other than a small business entity for the year of income that has not chosen to apply section 82KZMD of the ITAA 1936 to the expenditure) who is a taxpayer that is not an individual and does not carry on a business;
- (k) if the Investor exercises the Put Option on the Exercise Date, the Protection Fee and the Additional Amount (if any) will form part of the cost base and the reduced cost base of the Investor's units in the Funds that were acquired by the Bank pursuant to the Put Option, under item 2 of the table in subsection 134-1(1). Any capital gain or capital loss an Investor makes from exercising the Put Option is disregarded under subsection 134-1(4);
- (l) if the Investor does not exercise the Put Option on the Exercise Date, the Put Option will expire (subsection 247-30(2)). The Protection Fee and the Additional Amount (if any) will form part of the cost base (under subsection 110-25(2)) and the reduced cost base (under subsection 110-55(2)) of the Put Option. The Put Option Interest will form part of the third element of the cost base of the Put Option (subsection 110-25(4)). The Put Option Interest will not form part of the reduced cost base of the Put Option (subsection 110-55(3));
- (m) CGT event C2 will happen under section 104-25 if the Put Option is not exercised on the Exercise Date and expires. The Investor will make a capital loss that is equal to the reduced cost base of the Put Option;
- (n) the Loan Establishment Fee paid, if applicable, is deductible under section 25-25; and
- (o) the anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny the deductibility of the interest incurred by the Investor in respect of borrowings under an Investment Loan or an Interest and Put Protection Fee Loan.



## Scheme

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

- Application for a Product Ruling as constituted by documents and correspondence received on 17 February 2010, 26 February 2010, 17 March 2010, 9 April 2010, 13 April 2010 and 3 May 2010;
- **Product Disclosure Statement (PDS)** for the Macquarie Fusion Funds prepared by Macquarie Financial Products Management Limited as responsible entity (Responsible Entity or RE) for each Fusion Fund – Equity Trust (Equity Trust) and the Fusion Fund – Cash Trust (Cash Trust), dated 19 March 2010;
- **Loan and Security Agreement** (included in the PDS at Appendix C);
- **Put Option Agreement** (included in the PDS at Appendix D);
- **Constitution for the Fusion Fund – Cash Trust, dated 28 January 2003 and Amending Deeds dated 15 April 2009 and 30 April 2009**; and
- **Constitution for Fusion Fund – Perpetual Wholesale Australian Fund ARSN 103 530 632, dated 24 March 2003 and Amending Deeds dated 15 April 2009 and 30 April 2009**. The PDS states that **the Constitution of each Equity Trust** is the same in all material respects except for the name and ARSN of the Equity Trust, the description of the Underlying Managed Fund into which the Equity Trust will invest and the date of the Constitution.

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

21. The documents highlighted in paragraph 20 of this Ruling are those that will govern the scheme that an Investor will 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. The effect of these agreements is summarised as follows.

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

**Overview**

23. Following is a summary of the scheme:

***Fusion Funds – Units in Cash Trust and Equity Trust***

- (a) an investment in a Macquarie Fusion Fund involves the subscription for units in one of a number of Equity Trusts together with the subscription for corresponding units in the Cash Trust. The combined investment in each Equity Trust and the Cash Trust is referred to as units in a 'Fund' or 'Fusion Fund';
- (b) Investors subscribe for units in a Fund pursuant to the PDS. Investors will initially be required to invest 99.99% of their initial investment amount in one or more Equity Trusts and 0.01% of their initial investment in the Cash Trust;
- (c) each Equity Trust and the Cash Trust will be an open ended trust with a termination date no later than 80 years from its commencement;
- (d) all units in an Equity Trust will be issued at a price based on the prevailing net asset value of that Equity Trust and will be issued as fully paid units;
- (e) each Equity Trust will invest all application monies in an existing Underlying Managed Fund. Each Equity Trust will invest in a different Underlying Managed Fund. The Underlying Managed Funds are not listed on any stock exchange;
- (f) all units in the Cash Trust will be issued as partly paid units with a paid up amount of \$0.0001 and an effective unpaid amount of \$1.4999;
- (g) the Cash Trust will be divided into classes of units to which pools of assets (Property Pools), each consisting of fixed term deposits or similar investments, will be allocated. There will be a different Property Pool for each class of units in the Cash Trust. Each class of unit will correspond to units in an Equity Trust issued on particular dates. All units in a particular class will have identical rights to the income and capital of the Property Pool to which the class relates;
- (h) the assessable income of the Investors will include the net income of the Fund which will be calculated in accordance with the terms of the Cash Trust Constitution and the relevant Equity Trust Constitution.

***Threshold Management***

- (i) the RE will manage an Investor's investment in the Equity Trust and the Cash Trust according to a technique known as 'Threshold Management'. This technique attempts to achieve the result that the value of the Investor's investment in a Fusion Fund, including units acquired by the reinvestment of distributions, at the conclusion of the period ending 30 November 2015 (the 'Threshold Management Period') will be at least equal to the amount of their combined initial investment. The achievement of that result is, however, not guaranteed;
- (j) under Threshold Management, if the value of an Investor's units in a Fusion Fund falls below a sell trigger the Investor is deemed to have given a redemption request in respect of some of the Investor's units in the Equity Trust. The RE will redeem some of the Investor's units in that Equity Trust and apply the proceeds of that redemption to further pay up an amount on that Investor's corresponding units in the Cash Trust;
- (k) alternatively, if the value of an Investor's units in a Fusion Fund rises above a buy trigger, the RE will make a return of capital on the Investor's units in the Cash Trust and apply the proceeds to subscribe for further units in the corresponding Equity Trust on behalf of the Investor. This return of capital increases the amount which the RE, in accordance with Threshold Management, can call up on those units at a later time, hence fixing the effective maximum net paid up amount on the Cash Units at \$1.50 per unit;
- (l) the Equity Trust will invest all monies received pursuant to Threshold Management in the relevant Underlying Managed Fund;
- (m) the Cash Trust will invest all further amounts paid up in respect of its units pursuant to Threshold Management in fixed term deposits or similar investments;
- (n) in the exercise of Threshold Management, the RE will require an Investor to reinvest some or all of their distribution or redemption payments into new units in the Equity Trust or into capital subscriptions to further pay up units in the Cash Trust;

***Loans***

- (o) there are two credit facilities available to finance an investment in a Fund - an Investment Loan and an Interest and Put Protection Fee Loan.

*Investment Loan*

- (p) an Investor must enter into a full recourse Investment Loan to fund the initial subscription for their units in a Fund by execution of a Loan and Security Agreement with the Bank.
- (q) the Loan and Security Agreement provides for full recourse for the Bank in respect of the principal owing on an Investment Loan at the Maturity Date;
- (r) an Investor will not be obliged to redeem units in a Fusion Fund on the Maturity Date to repay an Investment Loan. It will be open to an Investor to repay that Investment Loan from their own sources and continue to hold their units in a Fusion Fund;
- (s) the Investment Loan is interest only with the principal payment due on 30 November 2015 (the 'Maturity Date'). Clause 3.4 of the Loan and Security Agreement provides that the Maturity Date can be extended. **This Product Ruling does not apply to a Maturity Date that is later than 30 November 2015;**
- (t) the interest rate will be determined by the Bank prior to the drawdown of the Investment Loan and in some cases may be varied during the term of the Investment Loan;
- (u) in respect of an Investment Loan, an Investor has 4 interest rate and payment options:
  - (i) Variable  
Interest is paid monthly in arrears for the term of the Investment Loan at an interest rate that may be varied each month. Investors in this option may be given the choice to pay their interest annually in advance from 30 June 2011;
  - (ii) Fixed to 29 June 2011  
Interest is paid annually in advance on each 30 June for the term of the Investment Loan at an interest rate which is fixed until 29 June 2011 and which may be varied each 30 June thereafter. Investors who use this option may be given the choice to pay their interest monthly in arrears from 30 June 2011; and
  - (iii) Fixed for the term  
Interest is paid annually in advance on each 30 June for the term of the Investment Loan at an interest rate which is fixed for the term of the loan.

- (iv) Fixed to a pre-agreed date and rate  
Interest is paid annually in advance on each 30 June until an agreed date (Fixed Rate Term) at an interest rate that is fixed until the end of the Fixed Rate Term, and thereafter (unless otherwise agreed) monthly in arrears at an interest rate which may be varied each month from the end of the Fixed Rate Term.

#### *Interest and Put Protection Fee Loan*

- (v) an Investor can also enter into an optional full recourse Interest and Put Protection Fee Loan which allows the Investor to fund the interest payment on the Investment Loan and the cost of the Put Option (the Protection Fee) for the first full financial year (if the Investor prepays that interest and wishes to take out an Interest and Put Protection Fee Loan to fund that prepayment and the Protection Fee);
- (w) Approved Investors who select a fixed interest Investment Loan and elect to pay annually in advance may be able to apply for further Interest and Put Protection Fee Loans to fund prepaid interest obligations on Investment Loans and the cost of the Put Option in subsequent periods;
- (x) the interest rate on an Interest and Put Protection Fee Loan will be determined by the Bank prior to drawdown of that loan. The term of an Interest and Put Protection Fee Loan equals the term of the prepaid interest period on the Investment Loan and is limited to twelve months. An Interest and Put Protection Fee Loan is repayable monthly in arrears by principal and interest repayments over the prepaid interest period on the Investment Loan immediately following the date the Interest and Put Protection Fee Loan is borrowed;
- (y) repayment of the Interest and Put Protection Fee Loan is a full recourse obligation of the Investor and the term of that loan cannot be extended;

#### **Commissions**

- (z) Information regarding the payment of upfront and trailing commissions by the Bank to financial advisers is set out in the PDS. Investors who want their financial advisers to be paid upfront commissions by the Bank are required to pay a Loan Establishment Fee to the Bank upon successful application for an Investment Loan;

- (aa) Investors who want their financial advisers to be paid trailing commissions by the Bank will have the interest rate on their Investment Loan increased by the chosen level of trailing commissions;

***Put Option***

- (bb) Investors will also be required to buy a Put Option from the Bank. The cost of the Put Option is the Protection Fee. The exercise price of the Put Option is the higher of the amount of the Investment Loan or any greater amount where a Profit Trigger has been reached (Protected Amount), and the value of the Fusion Fund units at the Settlement Date of the Put Option. If the Put Option is exercised on the Exercise Date, the Bank agrees to buy the Investor's units at the exercise price on the Settlement Date (expected to be on or before 30 November 2015). These proceeds are to be offset against the amounts outstanding on the Investment Loan;
- (cc) Investors who redeem any units prior to the Maturity Date will need to use their own funds to cover any shortfall between the value of those units and the relevant portion of the Investment Loan and will also lose the benefit of the Put Option in respect of those units;
- (dd) the Protection Fee is a fixed percentage of the Investor's Protected Amount and is payable either monthly in arrears or annually in advance to coincide with the interest payment obligations on the Investor's Investment Loan. If a Profit Trigger is reached that increases the Protected Amount, the Investor will be required to pay an additional Protection Fee.

**Assumptions**

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

- (a) the Investor is an Australian resident for taxation purposes;
- (b) the dominant purpose of the Investor in entering into and carrying out the scheme is to derive assessable trust income notwithstanding that the Investor may also derive capital gains from their participation in the scheme;

- (c) the Investor is not a trader in investments and is not treated for taxation purposes as trading in interests in a Fund, carrying on a business of investing in a Fund, or holding their interests in a Fund as trading stock or as a revenue asset;
- (d) in respect of any interest amounts paid in advance under the Investment Loan, these may be prepaid, but only in relation to a payment period of 12 months or less that ends on or before the last day of the income year following the expenditure year;
- (e) the scheme will be executed in the manner described in the Scheme section of this Ruling;
- (f) all dealings between the Investor and the Bank will be at arm's length;
- (g) at the time of the interest prepayment each of the two unit trusts comprising a Fund will have at least 300 unit holders; and
- (h) the Investor will not repay or partially repay the Investment Loan or the Interest and Put Protection Fee Loan prior to their relevant terms or terminate the scheme prior to the maturity date.

## 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

25. Interest paid on a borrowing used to acquire income producing assets, such as units in a unit trust, is generally treated as deductible under section 8-1 where it is expected that assessable income would be derived from the investment (see Taxation Ruling TR 95/33 which relates to subsection 51(1) of the ITAA 1936 which was the predecessor of section 8-1 of the ITAA 1997). Interest on an Investor's Investment Loan and, if applicable, the proportion of the interest incurred on the Interest and Put Protection Fee Loan that is used to pay interest on the Investment Loan, will be deductible under section 8-1 of the ITAA 1997.

26. The Put Option Interest, being the proportion of the interest on the Interest and Put Protection Fee Loan that corresponds to the part of the loan that is used to pay the Protection Fee, is not deductible under section 8-1.

27. Division 247 applies to the scheme as it is a capital protected borrowing (CPB). The Investor uses the Investment Loan to acquire an investment in the Fusion Fund and the Investor is wholly or partly protected against a fall in the market value of the investment. The investment in the Fusion Fund represents beneficial interests in unit trusts.

28. 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)).

29. Where a borrower enters into an Investment Loan, the amount reasonably attributable to capital protection, is worked out under the method statement in subsection 247-20(3), as set out in paragraph 19(b) of this Ruling.

30. Under step 1 of the method statement, the Total Amount incurred by the Investor under or in respect of the CPB for the income year, includes the Protection Fee and interest incurred on the Investment Loan and the Interest and Put Protection Fee Loan (if applicable) for the income year.



31. Where the Total Amount incurred by the Investor worked out under step 1 of the method statement is less than the total interest that would have been incurred by the Investor worked out under step 2 of the method statement, there is no amount reasonably attributable to the cost of capital protection. In these circumstances, the interest on the Investment Loan and (if applicable) the proportion of the interest on the Interest and Put Protection Fee Loan that is not attributable to the Protection Fee will be deductible under section 8-1.

32. Where the Total Amount incurred by the Investor is greater than the total interest that would have been incurred by the Investor worked out under step 2 of the method statement, the balance (the Excess Amount) is reasonably attributable to the cost of capital protection. In calculating the Additional Amount, the Excess Amount will be reduced by any actual payment for the Put Option (the Protection Fee) and the Put Option Interest in accordance with subsection 247-20(6). The Additional Amount, to the extent that it is greater than zero, constitutes a further cost of capital protection in addition to the Protection Fee for the Put Option and the Put Option Interest. The Put Option is a capital asset for an Investor in the Fusion Fund. Therefore, the sum of the Protection Fee, Put Option Interest and Additional Amount (if any) is capital in nature and not deductible under section 8-1.

## **Section 51AAA**

33. Under the scheme, it is contemplated that over the period of an Investor's involvement there will be assessable income derived by way of distributions of the net income of a Fund and net capital gains. As the Total Amount, to the extent that it is not reasonably attributable to the cost of capital protection, 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.

## **Section 82KL**

34. 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**

35. 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 for the purposes of Subdivision H**

36. Under section 328-110, an Investor carrying on a business in an income year will be a small business entity for that year (the current year) if:

- (a) the Investor carried on a business in the previous income year and the aggregated turnover for that year was less than \$2 million;
- (b) the aggregated turnover for the current year is likely to be less than \$2 million and, where the Investor carried on a business in each of the two previous income years, the aggregated turnover for each of those income years was less than \$2 million; or
- (c) the aggregated turnover for the current year, worked out as at the end of the year, is less than \$2 million.

**The eligible service period for the purposes of Subdivision H**

37. The prepaid interest charges on the Investment Loan allowable under section 8-1 of the ITAA 1997 are 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, to be expenditure incurred under an agreement in return for the doing of a thing under the agreement for the period to which the interest payment relates. The eligible service period in relation to a payment of loan interest is determined by reference to the period to which the interest relates, which is 12 months, and not to the period of the loan.

## **Sections 82KZME and 82KZMF – prepaid expenditure and tax shelter arrangements**

38. 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.

39. 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 a Fund, including the financing and management arrangements.

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

- the documents and facts described in the scheme at paragraphs 20 to 24 of this Ruling establish that Investors have fixed entitlements to all of the income and capital of an Equity Trust and the Cash Trust. Therefore, the prepaid interest deductible under section 8-1 of the ITAA 1997 incurred in respect of money borrowed to acquire units in a widely held unit trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- the Investor can reasonably expect to obtain 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 scheme are at arm's length.

41. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 42 to 47 of this Ruling.

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

42. 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 small business entity for the year of income that has not chosen to apply section 82KZMD of the ITAA 1936 to the expenditure; or
- a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

43. 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.

44. As the eligible service period in relation to a deductible interest payment under an Investment Loan is not longer 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 interest allowable under section 8-1 of the ITAA 1997 that is incurred under an Investment Loan.

**Sections 82KZMA and 82KZMD – prepaid non-business expenditure incurred by non-individuals and non-small business entities**

45. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for a taxpayer (other than a small business entity for the year of income that has not chosen to apply section 82KZMD to the expenditure) that is not an individual and does not incur the expenditure in carrying 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 wholly done within the expenditure year.

47. For these Investors, the deduction for prepaid interest on the Investment Loan will be apportioned over the relevant interest payment period.

**Section 110-25 and Division 134 – cost base of the Put Option**

48. If the Investor exercises the Put Option on the Exercise Date, any capital gain or capital loss an Investor makes from exercising the Put Option is disregarded (subsection 134-1(4)). The cost base and the reduced cost base of the Investor's units in the Funds that were acquired by the Bank pursuant to the Put Option will include the Protection Fee and the Additional Amount (if any) (item 2 of the table in subsection 134-1(1)).

49. If the Investor does not exercise the Put Option on the Exercise Date, the Put Option will expire (subsection 247-30(2)). The Protection Fee and the Additional Amount (if any) will form part of the cost base (under subsection 110-25(2)) and the reduced cost base (under subsection 110-55(2)) of the Put Option.

50. Where the Put Option expires, CGT event C2 will happen (paragraph 104-25(1)(c)). The capital proceeds on the expiry of the Put Option will be nil. Therefore, the Investor will make a capital loss from CGT event C2 that is equal to the reduced cost base of the Put Option.

51. The Put Option Interest will form part of the third element of the cost base of the Put Option (subsection 110-25(4)). It will not form part of the third element, or any other element, of the reduced cost base of the Put Option (subsection 110-55(3)).

## **Section 25-25 – Loan Establishment Fee**

52. The Loan Establishment Fee, if applicable, incurred by an Investor upon successful application for an Investment Loan will be an allowable deduction pursuant to section 25-25. The Loan Establishment Fee will be deductible on a straight line basis over the period of the shorter of:

- the term of the Investment Loan; or
- five years.

## **Part IVA**

53. Provided that the scheme ruled on is entered into and carried out as described (see paragraphs 20 to 24 of this Ruling), it is accepted that the scheme is an ordinary commercial transaction and that Part IVA of the ITAA 1936 will not apply.

## **Appendix 2 – Detailed contents list**

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

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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
- interest expense
- interest income
- prepaid expenses
- product rulings
- public rulings
- taxation administration

*Legislative references:*

- ITAA 1936
- ITAA 1936 51(1)
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- ITAA 1936 82KL
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- ITAA 1936 82KZL(2)(a)
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- ITAA 1997 104-25
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