



PR 2011/19 - Income tax: deductibility of interest in relation to investment in units in the Macquarie Flexi 100 Trust issued on or before 30 June 2014 - limited recourse borrowings

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 This document has changed over time. This is a consolidated version of the ruling which was published on *22 May 2013*



Product Ruling

Income tax: deductibility of interest in relation to investment in units in the Macquarie Flexi 100 Trust issued on or before 30 June 2014 – limited recourse borrowings

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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.

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No guarantee of commercial success

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

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 Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling part apply to the defined class of entities who participate in the scheme to which this Product 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 an investment in the Macquarie Flexi 100 Trust (the Fund) using a limited recourse loan (Limited Recourse Investment Loan) made by Macquarie Specialist Investments Lending Limited (the Loan Provider) and the grant of put options (the Put Options) over the investment by the Loan Provider; and a further borrowing from the Loan Provider, if it occurs, used to fund the payment of interest on the Limited Recourse Investment Loan (Interest Loan). The Limited Recourse Investment Loan and Interest Loan are in the form of the Loan and Put Option Agreement contained in section 5.1 of Part II of the Product Disclosure Statement dated 14 September 2011 that forms part of the scheme.
3. This Ruling does not deal with the taxation consequences of:
 - the 'Walk-Away' feature (see subparagraph 20(v) of this Ruling);
 - the termination of the scheme as described in subparagraph 20(s) of this Ruling;
 - fees paid by the Fund;
 - fees paid to the Responsible Entity; or
 - any upfront and trailing commissions, including any arrangement whereby commissions are rebated by a financial adviser to an Investor (see subparagraphs 20(w) and 20(x) 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:

- who enter into the scheme described in paragraphs 17 to 30 of this Product Ruling and execute relevant Agreements mentioned in paragraph 17 of this Product Ruling:
 - on or after the date this Product Ruling is published, being 16 November 2011, and on or before 30 June 2014;

and, at the time of entering into the scheme:

- 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
- they must have a realistic expectation of deriving assessable income from the investment that exceeds the expenditure incurred 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:

- do not hold their units for the full term, or who do not intend to derive assessable income from the investment that exceeds the deductible expenditure that they incur in order to invest in the scheme;
- are accepted to participate in the scheme specified below and who execute relevant Agreements mentioned in paragraph 17 of this Ruling before this Ruling is published or after 30 June 2014;
- choose a Full Recourse Investment Loan to fund their investment in the Fund;
- are superannuation fund trustees; 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 17 to 30 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

11. This Product Ruling applies prospectively from 16 November 2011, the date it is published. It therefore applies to the specified class of entities that enter into the scheme from 16 November 2011 to 30 June 2014 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 the Ruling and, to that extent, this Product Ruling will have no effect.

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

Note to promoters and advisers

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

Ruling

16. Subject to paragraph 3 of this Ruling and the assumptions in paragraph 30 of this Ruling:

- (a) income distributions by the Fund are included in the assessable income of an Investor, in accordance with Division 6 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936);
- (b) an amount equal to the interest charged on the Limited Recourse Investment Loan, reduced by an amount reasonably attributable to the cost of capital protection calculated under the method statement in subsection 247-20(3) will be deductible under section 8-1;
- (c) 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 expense incurred for interest on the Limited Recourse Investment Loan exceeds:
 - where the interest rate charged by the Loan Provider is a fixed rate for all or part of the term of the loan, the amount of the loan multiplied by the Adjusted Loan Rate (being the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Housing Loans at the time when the interest charge is first incurred during the term of the loan, or the relevant part of the term plus 100 basis points) (subsections 247-20(4) and 247-20(5)); and

- where the interest rate charged by the Loan Provider is a variable rate for all or part of the term of the loan, the amount of the loan multiplied by the average of the Adjusted Loan Rates during the term of the loan, or the relevant part of the term (subsection 247-20(5A));
- (d) the amount reasonably attributable to the cost of capital protection under Division 247, as worked out under subparagraph 16(c) of this Ruling, is treated as the cost of acquiring Put Options granted by the Loan Provider to the Investor under subsection 247-20(6). This amount is not deductible under section 8-1;
- (e) where an Investor enters into a Limited Recourse Investment Loan and a full recourse Interest Loan, Division 247 will not apply to the Interest Loan;
- (f) an amount equal to the expense incurred for interest on the Interest Loan will be deductible under section 8-1;
- (g) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction for the interest expense allowable under section 8-1 of the ITAA 1997;
- (h) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest expense allowable under section 8-1 of the ITAA 1997;
- (i) 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 a Limited Recourse Investment Loan;
- (j) section 82KZM of the ITAA 1936 will not apply to deny an Investor immediate deductibility of the prepaid interest on a Limited Recourse 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;

- (k) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for prepaid interest on borrowings under a Limited Recourse 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;
- (l) If an Investor does not exercise a Put Option on the relevant Put Option Exercise Date, the Put Option will expire (subsection 247-30(2)). CGT event C2 will happen under section 104-25 if a Put Option is not exercised on the relevant Put Option Exercise Date and expires. An Investor will make a capital loss that is equal to the reduced cost base of that Put Option under subsection 104-25(3);
- (m) The commercial debt forgiveness rules in Division 245 will not reduce the tax attributes of an Investor as a result of the debt forgiveness that occurs when the limited recourse provisions of the Limited Recourse Investment Loan come into effect if they redeem their units in the Fund, and the redemption proceeds will not fully repay the balance of the loan.
- (n) a Unit in the Fund is not a 'security' as defined in subsection 159GP(1) of the ITAA 1936;
- (o) Investors are deemed under subsection 272-5(3) of Schedule 2F to the ITAA 1936 to have fixed entitlements to all of the income and capital of the Fund;
- (p) the Loan Establishment Fee paid, if applicable, is deductible under section 25-25; and
- (q) 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 a Limited Recourse Investment Loan or an Interest Loan.

Scheme

17. 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 16 August 2011;

- **Product Disclosure Statement** dated 14 September 2011 and **Supplementary Product Disclosure Statement (SPDS)** dated 8 May 2012, **SPDS** dated 16 November 2012, **SPDS** dated 2 May 2013 and **SPDS** dated 6 May 2013 for the Macquarie Flexi 100 Trust prepared by Macquarie Financial Products Management Limited as responsible entity (Responsible Entity or RE);
- **Loan and Put Option Agreement**, contained in the PDS; and
- **Constitution for the Macquarie Flexi 100 Trust (the Constitution)**, dated 21 February 2008 and **Amending Deeds** dated 21 April 2009 and 6 May 2009.

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

18. The documents highlighted in paragraph 17 of this Ruling are those 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.

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

Overview

20. Following is a summary of the scheme.

The Macquarie Flexi 100 Trust

- (a) an investment in the Macquarie Flexi 100 Trust (the Fund) involves the subscription for ordinary fully paid units in the Fund, an Australian unit trust registered as a managed investment scheme;
- (b) the Fund will be an open ended trust with a termination date no later than 80 years from its commencement;

- (c) information regarding the Offers to subscribe for Units in the Fund, the corresponding Offer Open and Close dates, Unit Issue Dates and Maturity Dates will be provided on the Fund's website which is accessible at www.macquarie.com.au/flexi. **This Product Ruling applies to Investors who apply for units under the PDS and whose units are issued on the Unit Issue Date being on or before 30 June 2014;**
- (d) Units in the Fund will be divided into classes with the issue price of \$1 per unit. The classes of Units available for each Offer will be published on the Fund's website. The PDS describes the attributes and conditions that are attached to each unit class. These include the reference asset exposure attributed to a unit (Investment Opportunities) and the corresponding investment return in the form of a distribution (Payoff Category);
- (e) the Investment Opportunities and the corresponding Reference Assets attributable to any one class of units to be offered in the Fund are specified in the PDS. The Investment Opportunities and References Assets may include, but are not limited to, the following:

Investment Opportunities	Reference Assets
Asian Alpha	the Macquarie Asian Alpha Fund
Asian Equity	weighted exposure to Asian shares through the Tracker Fund of Hong Kong (20%), Hang Seng H-Share Index ETF (20%), MSCI Taiwan Index (20%), Kospi 200 Index (20%) and the MSCI Singapore Cash Index (20%)
Australian Concentrated Equity	a fixed basket of 13 shares with large market capitalisation listed on the ASX
Australian Equity	the S&P/ASX200
Australian Equity Focus	a fixed, equally-weighted basket of 20 shares with large market capitalisation listed on the ASX
Best-of Basket	This strategy delivers upside exposure to the best performing of two baskets: the ASX Tilt basket and the PIMCO Tilt basket.
BlackRock Global Allocation	the BlackRock Global Allocation Fund
Bond Fund Tilt Basket	a fixed basket consisting of the PIMCO GIS Total Return Bond Fund (60%),

	S&P/ASX 200 Index (20%) and the Winton Global Alpha Fund (20%)
BRIC Equity	an equally weighted basket comprising the iShares MSCI Brazil Index Fund, Market Vectors Russia ETF, Wisdomtree India Earnings Fund and the Hang Seng H-Share Index ETF
Commodities Long/Short (Max 300% Participation)	MLCI3VLS Index. A volatility adjusted index (with maximum participation of 300% and Benchmark Volatility of 4%) seeking to take advantage of structural inefficiencies in commodities markets.
Commodities Long/Short (Max 600% Participation)	MLCXWALS Index. A volatility adjusted index (with maximum participation of 600% and Benchmark Volatility of 10%) seeking to take advantage of structural inefficiencies in commodities markets.
Commodities Select	an equally weighted basket of 5 commodities which will be reviewed and reset annually
Foreign Currency	Foreign Currency Exchange Rates. Provides exposure to the relative appreciation in price of one foreign currency relative to another.
Low Volatility US Equity	an ETF which tracks the S&P 500 Low Volatility Index, designed to measure the performance of the least volatile stocks within the S&P 500 Index.
US Equity	the S&P 500 Index
US Technology	a fixed, equally-weighted basket of 10 shares with large market capitalisation listed on US exchanges

- (f) the Payoff Categories to be offered in the Fund are specified in the PDS as follows:
- Fixed Distribution – term varies and may be up to 5.5 years, and
 - Variable Distribution – term varies and may be up to 6 years;
- (g) the Fund will have portfolios of assets and liabilities that will be referable to a particular Unit Class (Class Portfolio). Each of these Class Portfolios will be provided exposure to a Reference Asset through the Swap Agreement and Collateral Agreement to be entered by the Fund and the Swap Counterparty and Collateral Counterparty, respectively;

- (h) under each relevant Swap Agreement, the Swap Counterparty will be required to pay the trustee of the Fund during the Term (the period from the Unit Issue Date to Maturity) an amount reflecting the Distributions specified in subparagraph 20(l);
- (i) under the Collateral Agreement the Fund is required to place the Cash Collateral with the Collateral Counterparty;
- (j) the Cash Collateral is equal to the subscription amount for units issued and is deposited with the Collateral Counterparty as collateral for the Fund's obligations under the Swap Agreement;
- (k) some or all of the interest earned from the Cash Collateral will be applied to make payments to the Swap Counterparty under the Swap Agreement during the Term;
- (l) in return for the interest paid to the Swap Counterparty, the Swap Counterparty will pay coupons or distributions to the Fund as follows:
- for the Fixed Distribution Classes – a fixed annual amount, payable at the end of each year throughout the Term, and potentially a fixed amount payable at Maturity. An additional variable amount may be paid at Maturity depending on the performance of the Reference Asset over the Term, and
 - for the Variable Distribution Classes – a variable amount may be paid annually during the Term based on the positive performance of the Reference Asset during the relevant Distribution Period;
- (m) as each Class Portfolio will be covered by the above Agreements, the Investors in a Fixed Distribution Class will therefore be entitled to a fixed annual Distribution throughout the Term as well as a distribution relating to the Reference Asset Gain (if any), whilst Investors in a Variable Distribution Class may be entitled to an annual Distribution based on the positive performance (if any) of the Reference Asset during the relevant Distribution Period;

- (n) the Constitution sets out the provisions relating to the calculation of the net income of the Fund and the distribution of distributable income from the Fund. **This Product Ruling only applies where an Investor is entitled to benefit from distributions as set out in the Constitution;**
- (o) the nature of distributions that will be paid to Investors in respect of their units are specified in subparagraph 20(l) of this Ruling. Certain units will have caps placed on the amount that will be paid to Investors. For Fixed Distribution Classes, the cap will limit the amount that could be paid to an Investor at Maturity and for Variable Distribution Classes, the cap will limit the amount of annual distribution that could be paid to an Investor;
- (p) for investments in any of the Fixed Distribution Classes, Hurdles may be used to determine whether a Reference Asset Gain will be paid at Maturity. If the closing level of a Reference Asset is greater than the Hurdle, then the Reference Asset Gain will be paid. However, the actual amount that will be paid to an Investor may be subject to the Term or Share Performance Cap;
- (q) for investments in any Variable Distribution Classes, there will be no Reference Asset Gains. Each year a cap may be placed on the Reference Asset Level, and accordingly may cap the value of the potential annual Distributions that an Investor may realise at the end of each Distribution Period. Hurdles may be used to determine whether an annual Distribution will be paid;
- (r) the rate of the indicative and minimum performance caps for both Fixed and Variable Distribution Classes will be made available on the Fund's website. Actual performance caps for each Class will be set on or before the Swap Start Date which is on or after the relevant Unit Issue Date for that Class. The potential returns from an investment will be greater than the interest rate charged on the credit facilities described in subparagraphs 20(t) to (u);

- (s) if the actual performance cap of a unit is less than the minimum performance cap outlined on the Fund's website, then an Investor's participation into the scheme in respect of that unit will be terminated. The consequences of this termination include the termination of the Loan and Put Option Agreement and the refund of the prepaid interest and, for Distribution Period 1, the refund of the Loan Establishment Fee;

Credit facilities

- (t) there are two credit facilities available to finance an investment in the Fund. One is an Investment Loan that Investors must enter into to finance the initial subscription for their units in the Fund. This compulsory Investment Loan can be taken as a Limited Recourse Investment Loan or Full Recourse Investment Loan. **This Product Ruling applies to Limited Recourse Investment Loan Investors;**
- (u) the second credit facility available is an optional full recourse Interest Loan which allows the Investor to fund the interest payment on the Limited Recourse Investment Loan;

'Walk-Away' feature

- (v) Investors can exercise the 'Walk-Away' feature described in the PDS and the Loan and Put Option Agreement. This feature involves the ability of Investors to exercise the Put Options as described in paragraph 29 of this Ruling before the Maturity Date;

Commissions to financial advisers

- (w) information regarding the payment of upfront and trailing commissions by the Responsible Entity to financial advisers is set out in the PDS. If an Investor indicates in their Application Form that an upfront commission rebate arrangement exists, then the Loan Establishment Fee payable will be reduced by the rebated amount; and

- (x) if an Investor indicates in their Application Form that a trailing commission rebate arrangement exists, then the interest payable on the Limited Recourse Investment Loan will be reduced by the rebated amount. **This Product Ruling does not rule on the tax consequences of any trailing commission rebate arrangement.**

Loan and Put Option Agreement

21. The Loan and Put Option Agreement will be between the Loan Provider and an Investor who chooses a Limited Recourse Investment Loan to finance their investment in the Fund. This agreement also sets out the terms of the optional full recourse Interest Loan.

22. The Limited Recourse Investment Loan will be limited recourse for the Loan Provider in respect of the principal owing on a Limited Recourse Investment Loan. Accordingly, any amount payable by an Investor to the Loan Provider is limited to the Investor's units and their proceeds.

23. The Loan and Put Option Agreement provides that Investors may redeem their units in the Fund on the Maturity Date and they may also be given the opportunity to retain their units. If Investors are given the option to retain their units in the Fund, they will still be required to repay their Limited Recourse Investment Loan and any Interest Loan at Maturity. **This Product Ruling does not apply to schemes entered into after the Maturity Date including the retention of units by Investors.**

24. The terms of the agreement in respect of the Limited Recourse Investment Loan include as follows:

- interest is payable annually in advance for the term of the loan. The first interest payment date will be on the Unit Issue Date, and each subsequent interest payment date will be on or around the anniversary of each Unit Issue Date (each, an Investment Loan Interest Payment Date);
- the interest rate is fixed for the prepaid interest period (which will be twelve months or less). The indicative interest rate for the first interest period will be available on the Fund website. The actual interest rates will be determined by the Loan Provider on or around one week prior to the relevant Unit Issue Date and published on the Fund website;
- as security for the Investor's obligations, a Mortgage will be granted over the Mortgaged Property which includes the units that Investor holds and their proceeds; and

- the agreement will end at the Maturity Date for each class of units.

25. The agreement also sets out the terms of the full recourse Interest Loan that is available to an Investor to fund the interest payment on the Limited Recourse Investment Loan due on the Unit Issue Date and subsequent Investment Loan Interest Payment Dates. The Interest Loan is repayable by monthly in arrears principal and interest repayments over the prepaid interest period on the Limited Recourse Investment Loan and is limited to a period of twelve months and the interest is fixed for that period. The term of the Interest Loan can not be extended and the indicative interest rate for an Interest Loan for the first interest period will be available on the Fund website.

26. The obligations of an Investor (who is not a Superannuation investor) under the Loan and Put Option Agreement will be secured by a Mortgage to be granted by the Investor in respect of the Units held and all related rights as holder of those Units (including proceeds) and also by the Collateral Security to be granted by the Responsible Entity over the Investor's interest in the Cash Collateral.

27. A Loan Establishment Fee of 2% of the Limited Recourse Investment Loan may be charged by the Loan Provider. This fee is payable in full on the Unit Issue Date if an Interest Loan is not utilised.

28. However, for Investors who take out an Interest Loan, the Loan Establishment Fee (if applicable) is payable by 12 monthly repayments over the first year of the investment. These additional payments will be direct debited from an Investor's nominated bank account at the same time as the Interest Loan repayments.

Put Option

29. The Loan and Put Option Agreement also sets out the terms of the grant of Put Options by the Loan Provider. As a consideration for this grant, an Investor promises to pay the Put Option Premium. If not exercised in accordance with this agreement, each Put Option automatically lapses on the relevant Put Option Exercise Date.

Assumptions

30. 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 an amount of assessable trust income from the investment that exceeds the total expenses incurred;
- (c) the Investor is not a trader in investments and is not treated for taxation purposes as trading in interests in

the Fund, carrying on a business of investing in the Fund, or holding their interests in the Fund as trading stock or as a revenue asset;

- (d) in respect of any interest amounts paid in advance under the Limited Recourse 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 documentation and in the Scheme section of this Ruling;
- (f) all dealings between the Investor and Macquarie group of companies including the Responsible Entity and the Loan Provider will be at arm's length;
- (g) at the time of the prepayment the Fund will have at least 300 unit holders;
- (h) the Investor will not repay or partially repay the Limited Recourse Investment Loan prior to its relevant term or terminate the scheme prior to the Maturity Date; and
- (i) the Investors will not enter into the scheme with the intention to terminate their participation in the scheme early.

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

31. 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). Investors in the Fund will derive assessable income in the form of fixed distributions (and if available, a Reference Asset Gain) for Fixed Distribution Classes, and variable distributions for Variable Distribution Classes. The assessable income from their investments is expected to be in excess of the expenditure they incurred. However, the ability to claim interest deductions may be subject to Division 247.

32. Section 247-10 describes when a borrowing under an arrangement satisfies the requirements as a capital protected borrowing. Subsection 247-10(1) states:

An arrangement under which a borrowing is made, or credit is provided, is a **capital protected borrowing** if the borrower is wholly or partly protected against a fall in the market value of a thing (the **protected thing**) to the extent that:

- (a) the borrower uses the amount borrowed or credit provided to acquire the protected thing; or
- (b) the borrower uses the protected thing as security for the borrowing or provision of credit.

33. Subsection 247-10(2) states:

That protection is called **capital protection**.

34. Where an Investor enters into a Limited Recourse Investment Loan in order to acquire units in the Fund, that Investor is wholly or partly protected against a fall in the market value of the acquired units through the operation of Put Options that the Investor takes out under the Loan and Put Option Agreement.

35. However, under clause 2.1 of the Loan and Put Option Agreement in the PDS dated 14 September 2011, the Loan Provider will only provide a loan to an Investor where that Investor has paid all of the interest that is payable on the Limited Recourse Investment Loan on the Investment Loan Drawdown Date, or where the Investor has applied for an Interest Loan and this has been accepted by the Loan Provider.

36. Where units are redeemed by the Investor at Maturity, the limited recourse aspect of the Limited Recourse Investment Loan means that the amount payable by the Investor to the Loan Provider is limited to the proceeds of the redeemed units (paragraph 1.5(a) of Part 1 of the PDS dated 14 September 2011). Clause 10 of the Loan and Put Option Agreement in the PDS dated 14 September 2011 reinforces this limitation where it is stated:

...your [the Investor] liability to pay any amount in respect of the Investment Loan under this agreement may only be discharged from, and our [the Loan Provider] recourse against you [the Investor] in respect of any such amount is limited to, the amount which we [the Loan Provider] can obtain by enforcing our rights relating to the Mortgaged Property

37. Under clause 1.4 of the Loan and Put Option Agreement in the PDS dated 14 September 2011, where an Investor takes out a Limited Recourse Investment Loan, that Investor will be granted Put Options by the Loan Provider in consideration for the Investor's promise to pay the Put Option Premium. The cost of capital protection associated with taking out the Put Options is not deductible for tax purposes.

38. However, the amount that is reasonably attributable to the cost of capital protection is embedded in the total amount that an Investor has to pay the Loan Provider in relation to the Limited Recourse Investment Loan. Accordingly, the calculation of the cost of capital protection is worked out under step 3 of the method statement in subsection 247-20(3).

39. Clause 5 of the Loan & Put Option Agreement in the PDS dated 14 September 2011 describes the situation where the Loan Provider may offset an outstanding loan amount against the sale price of the Put Property where an Investor exercises a Put Option on the Put Option Exercise Date. Clause 5 states:

Each Put Option constitutes an irrevocable offer (by the Loan Provider to the Investor) to, on effective exercise of that Put Option, buy the Put Property for the Sale Price on the relevant Put Option Exercise Date (subject to certain conditions).

40. However, a condition in the Loan & Put Option Agreement in the PDS dated 14 September 2011 (at clause 5(c)) mentions that the Loan Provider may set-off the Outstanding Money in relation to each Loan against the Sale Price payable (by the Loan Provider to the Investor) under clause 5. Accordingly, the Put Option arrangements provide some form of capital protection for an Investor.

41. Under the arrangement where an Investor chooses to enter into a full recourse Interest Loan in addition to a limited recourse Investment Loan only the borrowing under the limited recourse Investment Loan is considered to be subject to capital protection.

42. An Interest Loan can only be taken out by an Investor on a full recourse basis. Paragraph 1.5(b) of Part 1 of the PDS dated 14 September 2011 confirms the full recourse nature of this type of loan. There is no element of capital protection connected with this type of loan.

43. The Loan Provider is entitled to apply the proceeds from the redemption of an Investor's units to effectively meet all outstanding loan amounts of the Investor at Maturity. However, as the Interest Loan is issued on a full recourse basis, the Investor will need to use their own funds to cover the shortfall (including any break costs), that is associated with this loan.

44. Division 247 sets out a methodology for reasonably attributing a cost to the capital protection obtained by a borrower under a capital protected borrowing. 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)).

45. Under the scheme, the amount reasonably attributable to the cost of capital protection afforded by the limited recourse provisions of the loan is worked out according to the method statement in subsection 247-20(3) as set out in subparagraph 16(c) of this Ruling. This amount is treated as the cost of the Investor's Put Option under subsection 247-20(6).

46. For an Investor in the scheme, the 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 Limited Recourse Investment Loan will be deductible under section 8-1 only to the extent that it does not constitute the cost of capital protection.

Section 51AAA

47. 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 the Fund. As interest will be deductible under section 8-1 of the ITAA 1997, section 51AAA of the ITAA 1936 has no application to an Investor.

Section 82KL

48. 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

49. 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

50. 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

51. The prepaid interest charges on the Limited Recourse 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

52. 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.

53. 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' includes all the contractual arrangements and activities associated with the participation in a Fund, including the financing and management arrangements.

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

- the documents and facts described in the scheme at paragraphs 17 to 30 of this Ruling establish that Investors have fixed entitlements to all of the income and capital of the Fund. Therefore, the prepaid interest deductible under section 8-1 is 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 will be conducted at arm's length.

55. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 56 to 61 of this Ruling.

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

56. 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.

57. 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.

58. As the eligible service period in relation to a deductible interest payment under a Limited Recourse 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 a Limited Recourse Investment Loan.

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

59. 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.

60. 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.

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

Division 110 – cost base of the Put Options

62. As the Loan and Put Option Agreement specifies more than one occasion on which the capital protection can be invoked, the income tax legislation applies as if there were a separate Put Option for each of those occasions, being each Put Option Exercise Date (subsection 247-25(1)).

63. The proportion of the Put Option Premium that is reasonably attributable to each Put Option is taken to have been incurred for that Put Option (subsection 247-25(1)). The proportion of the Put Option Premium that is reasonably attributable to each Put Option is the Put Option Premium multiplied by the number of days from the previous Put Option Exercise Date (or, in relation to the first Put Option Exercise Date, from the Unit Issue Date) to the Put Option Exercise Date applicable to that Put Option, and divided by 365. That proportion of the Put Option Premium 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.

64. If an Investor does not exercise a Put Option on the relevant Put Option Exercise Date, that Put Option will expire (subsection 247-30(2)). Where a 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, an Investor will make a capital loss from CGT event C2 that is equal to the reduced cost base of the Put Option.

Commercial debt forgiveness

65. The Limited Recourse Investment Loan is a commercial debt under section 245-10.

66. Where the limited recourse provisions of the Limited Recourse Investment Loan come into effect, an Investor is not required to repay the shortfall between the loan balance and the redemption proceeds of the units. This will result in the forgiveness of a commercial debt at that time, under paragraph 245-35(a).

67. Under Division 245, where the forgiveness of a commercial debt results in the Investor having a positive 'net forgiven amount', the Investor will be required to reduce certain tax attributes that could otherwise reduce their taxable income (in the same or a later income year), to the extent of the net forgiven amount.

68. To calculate the net forgiven amount of a debt, it is first necessary to calculate the 'gross forgiven amount' of a debt. In the Investor's circumstances, Division 245 will have no practical effect as there will be no gross forgiven amount in respect of the Limited Recourse Investment Loan. The gross forgiven amount is equal to the value of the debt when it is forgiven less the amount (if any) that is offset against the value of the debt when it is forgiven.

69. The value of the Limited Recourse Investment Loan (being a debt owed by an Investor) when it is forgiven is worked out under subsection 245-60(1). Subsection 245-60(1) applies because, under subsection 245-60(2):

- (a) the Investor will have incurred the debt directly in respect of financing the acquisition of property by the Investor; and

- (b) the creditor's rights against the Investor in the event of default in the payment of the debt or interest will be, just before the debt is forgiven, limited to rights in respect of a mortgage or other security over the property.

70. Under subsection 245-60(1), the value of the Limited Recourse Investment Loan when it is forgiven is the market value at that time of the creditor's rights mentioned in paragraph 245-60(2)(b) (being the redemption price of the units at that time, which is based on the net asset value per unit for the relevant class of units). This is because the creditor has no right to recover the shortfall between the loan balance and the redemption proceeds of the units.

71. The Limited Recourse Investment Loan is a 'moneylending debt' (being a debt resulting from a loan of money in the ordinary course of a business of lending money carried on by the creditor, the Loan Provider) and neither of items 4 and 6 of the table in subsection 245-65(1) apply. Therefore, item 1 of the table in subsection 245-65(1) will apply.

72. The amount that is offset against the value of a debt when it is forgiven is the market value, at the time of the forgiveness, of each item of property (other than money) that the debtor (an Investor) has given as a result of, or in respect of, the forgiveness of the debt. The market value of this property (the Investor's interest in the units in the Fund) will be the redemption price of the units at the time of the forgiveness.

73. Therefore, as the value of the Limited Recourse Investment Loan when it is forgiven will be equal to the amount that is offset against the value of the loan when it is forgiven, there will be no gross forgiven amount in respect of the loan (subsection 245-75(2)).

74. Accordingly, the commercial debt forgiveness rules in Division 245 will not reduce the tax attributes of an Investor as a result of the debt forgiveness that occurs when the limited recourse provisions of the Limited Recourse Investment Loan come into effect.

Subsection 159GP(1) – a Unit in the Fund is not a 'security'

75. Subsection 159GP(1) of the ITAA 1936 defines the term 'security'. Units in a unit trust will not be a security under paragraphs (a), (b) or (c) of the definition in subsection 159GP(1). Furthermore, units in a unit trust will not fall within the definition in paragraph (d) of subsection 159GP(1) unless there is a contract between the 'manager' of the unit trust (now commonly referred to as the responsible entity) and the unit holder under which there is a liability to pay an amount, and on the facts, the contract is found to be debt like (see paragraphs 4(ii) and 34 to 39 of Taxation Ruling TR 96/14).

76. A unit in the Fund is not considered to be a contract between the Responsible Entity and the unit holder, nor are the obligations between the Responsible Entity and the unit holder considered to be debt like. Therefore, a unit in the Fund does not meet the definition of security under subsection 159GP(1) of the ITAA 1936.

Section 25-25 – Loan Establishment Fee

77. The Loan Establishment Fee, if applicable, incurred by an Investor upon successful application for a Limited Recourse 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 Limited Recourse Investment Loan; or
- five years.

Part IVA

78. Provided that the scheme ruled on is entered into and carried out in the manner described in the scheme documentation and in the Scheme section of this Ruling including the Assumptions (see paragraphs 17 to 30 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

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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:

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 - ITAA 1936 82KZL(1)
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