



***PR 2015/3 - Income tax: deductibility of interest in relation to investment in units in the Macquarie Flexi 100 Trust issued on or before 30 June 2018 - Flexi Professional***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *23 May 2018*



## 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 2018 – Flexi Professional

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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.

[Note: This is a consolidated version of this document. Refer to the Legal Database (<https://www.ato.gov.au/law>) to check its currency and to view the details of all changes.]

### **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

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This Product Ruling has been given on the basis that the entity(s) who applied for the Product Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Product Ruling.

## What this Ruling is about

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1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling part apply to the defined class of entities who participate 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 an investment in the Macquarie Flexi 100 Trust (the Fund) using a limited recourse loan (Investment Loan) made by Macquarie Specialist Investments Lending Limited (the Loan Provider) and, if applicable, the grant of put options (the Put Options) over the investment by the Loan Provider. It also covers any further loan that is used to fund the payment of interest on the Investment Loan (referred to as the Interest Loan). The Investment Loan and Interest Loan are in the form of the Loan and Put Option Agreement contained in section 11 of the Macquarie Flexi Professional Information Memorandum (Information Memorandum) dated 3 April 2015 that forms part of the scheme. Units in the Fund offered under the Information Memorandum dated 3 April 2015 are only available to 'wholesale clients' as defined in the *Corporations Act 2001*.
3. This Product Ruling does not address:
  - the tax consequences of the 'Walk-Away' feature (see subparagraph 19(u) of this Ruling)
  - the tax consequences of the termination of the scheme as described in subparagraph 19(r) of this Ruling
  - the tax consequences of the exercise of an Investor's Put Option
  - the tax consequences of fees paid by the Fund
  - the tax consequences of fees paid to the Responsible Entity
  - the tax consequences of any upfront and trailing commissions, including any arrangement whereby commissions are rebated by a financial adviser to an Investor (see paragraphs 19(v) and 19(w) of this Ruling), and

- whether the scheme constitutes a financial arrangement for the purposes of Division 230 (Taxation of financial arrangements).

**Class of entities**

4. This part of the Product Ruling specifies which entities:

- are subject to the taxation obligations, and
- can rely on the tax benefits,

set out in the Ruling section of this Product Ruling.

5. The class of entities who can rely on the Ruling section of this Product Ruling consists of those entities:

- who enter into the scheme described in paragraphs 16 to 29 of this Product Ruling and execute relevant Agreements mentioned in paragraph 16 of this Product Ruling on or after the date this Product Ruling is published and on or before 30 June 2018

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 deductible expenditure incurred in connection with the investment.

These entities are referred to as Investor/s.

6. The class of entities who can rely on the Ruling section of this Product Ruling does **not** include entities that:

- do not intend to 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 into the scheme described in paragraphs 16 to 29 of this Product Ruling and execute relevant Agreements mentioned in paragraph 16 of this Product Ruling before the date of this Product Ruling or after 30 June 2018
- 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 16 to 29 of this Product 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.

## **Date of effect**

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10. This Product Ruling applies prospectively from 1 April 2015, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 1 April 2015 to 30 June 2018 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.

11. 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**

12. 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.

13. 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**

14. 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**

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15. Subject to paragraph 3 of this Product Ruling and the assumptions in paragraph 29 of this Product 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 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 Investment Loan exceeds 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)).
- (d) The amount reasonably attributable to the cost of capital protection under Division 247, as worked out under subparagraph 15(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 an 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 an Investment Loan.
- (j) 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.
- (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 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) that 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 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.
- (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 an Investment Loan or an Interest Loan.

## Scheme

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16. 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 2015
- Macquarie Flexi Professional Information Memorandum dated 3 April 2015, Supplementary Information Memorandum dated 29 May 2017 and Supplementary Information Memorandum dated 14 May 2018 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 Information Memorandum, and
- **Constitution** for the Macquarie Flexi 100 Trust (the Constitution) dated 21 February 2008 and Amending Deeds dated 21 April 2009, 6 May 2009 and 6 September 2011.

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

17. The documents highlighted in paragraph 16 of this Product Ruling are those that an Investor will enter into or be a party to. 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. Unless otherwise defined, capitalised terms in this Product Ruling take their meaning as per the Information Memorandum referred to in paragraph 16 of this Ruling.

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

**Overview**

19. 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. The minimum amount required to be invested in the Trust by each Investor will be \$500,000 (or less subject to the discretion of the Responsible Entity).
- (b) The Fund is an open ended trust with a termination date no later than 80 years from its commencement.
- (c) The key terms of each Offer will be set out in the relevant Term Sheet, containing information such as the Offer open and Close dates, Issue Dates and Maturity Dates. Each Term Sheet forms part of the Information Memorandum and can be obtained from the Fund's website at [www.macquarie.com.au/flexi](http://www.macquarie.com.au/flexi) and/or by contacting the Responsible Entity on 1800 080 033. **This Product Ruling applies to Investors who apply for Units under the Information Memorandum and whose Units are issued on the Issue Date being on or before 30 June 2018.**
- (d) Units in the Fund will be divided into Classes with the issue price of \$1 per Unit. The Information Memorandum describes the attributes and conditions that are attached to each Unit Class. These include the reference asset exposure attributed to a Unit (Reference Assets) and the corresponding investment return in the form of a distribution.
- (e) The Reference Assets attributable to any one Class of Units to be offered in the Fund are specified in the Information Memorandum. The Reference Assets may include the following:

<b>Reference Asset</b>	<b>Description</b>
Asian Equity Basket	Weighted basket of stock market indices or index tracking funds, including some or all of the Hang Seng H-Share Index ETF, Tracker Fund of Hong Kong, MSCI Taiwan Index, KOSPI 200 Index and MSCI Singapore Index
Australian Equity	The S&P/ASX 200 Index
Australian Equity Focus Basket	A weighted basket comprising at least 2 ASX-listed shares with large market capitalisation

<b>Reference Asset</b>	<b>Description</b>
Australian Listed Securities	A basket comprising one or more securities listed on the ASX
Best-of Basket	The best performing of two baskets: the ASX Tilt Basket and the Bond Fund Tilt Basket
Bond Fund Tilt Basket	A fixed basket providing exposure to the PIMCO GIS Total Return Bond Fund (60%), S&P/ASX 200 Index (20%) and Winton Global Alpha Fund (20%)
Bond Fund Tilt (US) Basket	A fixed basket providing exposure to the PIMCO GIS Total Return Bond Fund (60%), S&P 500 Index (20%) and Winton Global Alpha Fund (20%)
Enhanced Australian Equity Focus Basket	A basket comprising a number of ASX-listed shares with large market capitalisation. The weight for each share within the basket will be determined at the Swap Valuation Date based on performance
European Equity Classes: EURO STOXX 50® Index	Provides a blue-chip representation of super sector leaders in the Eurozone. The index is a market capitalisation weighted index of 50 stocks from 12 Eurozone countries
Funds Basket	A fixed basket providing exposure to the PIMCO GIS Income Fund and Winton Global Alpha Fund <sup>1</sup>
Income Fund	The PIMCO GIS Income Fund
International Basket	A basket comprising the S&P 500 Index, the EURO STOXX 50 Index, the iShares Asia 50 ETF and the Winton Global Alpha Fund
International Listed Securities	A basket comprising one or more internationally-listed securities
International Low Volatility Basket	US and Eurozone-focused indices over equities with relatively low one year realised volatility, and a basket of indices and ETFs with exposure to equities in Hong Kong, Singapore, South Korea and Taiwan
US Equity	The S&P 500 Index
US Equity Focus Basket	A basket comprising at least 2 shares listed on US exchanges with large market capitalisation

<sup>1</sup> From the issue of the Supplementary Information Memorandum dated 14 May 2018, the description of this Reference Asset will be 'A weighted basket consisting of at least 2 managed funds or exchange traded funds'.

Reference Asset	Description
US Low Volatility	The Barclays US Low Volatility Equity Index invests in US stocks with low volatility relative to other US stocks and aims to provide higher risk-adjusted returns than a broad equity index

- (f) All Classes may pay fixed Distributions. The Term of each Offer varies and may be between 6 months and 8 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 Issue Date to Maturity) an amount reflecting the Distributions specified in subparagraph 19(l) of this Ruling.
- (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 may pay to the Fund 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 (the Reference Asset Gain) may be paid at Maturity depending on the performance of the Reference Asset over the Term.
- (m) As each Class Portfolio will be covered by the above Agreements, the Investors may therefore be entitled to a fixed annual Distribution throughout the Term and potentially a fixed Distribution at Maturity as well as a distribution relating to the Reference Asset Gain (if any).

- (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) Certain Units will have caps placed on the amount that will be paid to Investors. The cap will limit the amount of Reference Asset Gain that could be paid to an Investor at Maturity.
- (p) Hurdles may be used to determine whether a Reference Asset Gain will be paid at Maturity. If the Final Investment 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) The rate of the indicative and minimum Performance Caps will be set out in the relevant Term Sheet. Actual Performance Caps for each Class will be set on or before the Swap Start Date which is on or after the relevant 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 19(s) to (t) of this Ruling.
- (r) 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 the first Distribution Period, the refund of the Loan Establishment Fee (if any).

***Credit facilities***

- (s) There is a credit facility available to finance an investment in the Fund. This is an Investment Loan that Investors must enter into to finance the initial subscription for their Units in the Fund. This compulsory Investment Loan is limited recourse. The interest rate is fixed for 12 months on or around the anniversary of each Issue Date.
- (t) The second credit facility available is an optional full recourse Interest Loan which allows the Investor to fund the interest payments on the Investment Loan.

***'Walk-Away' feature***

- (u) Investors can exercise the 'Walk Away' feature, if applicable, described in the Information Memorandum and the Loan and Put Option Agreement. This feature involves the ability of Investors to exercise the Put Options as described in paragraph 28 of this Ruling before the Maturity Date.

***Commissions to financial advisers***

- (v) Information regarding the payment of upfront and trailing commissions by the Responsible Entity to financial advisers is set out in the Information Memorandum. 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. That is the Loan Provider will not charge a Loan Establishment Fee where the Investor and financial adviser agree that the financial adviser will not be paid an upfront commission.
- (w) 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 in the second and subsequent years may be reduced by the rebated amount. **This Product Ruling does not rule on the tax consequences of any upfront or trailing commission rebate arrangement.**

**Loan and Put Option Agreement**

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

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

22. 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 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.**

23. The terms of the agreement in respect of the Investment Loan are:

- Interest is payable annually in advance for the term of the loan. The first interest payment date will be on the Issue Date, and each subsequent interest payment date will be on or around the anniversary of each 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 relevant Term Sheet. The actual interest rates will be determined by the Loan Provider on or around one week prior to the relevant Issue Date and, if different to the indicative interest rate, published on the Fund website. Where the Walk Away feature does not apply, the actual interest rate will be less than the adjusted loan rate provided under subsection 247 20(5), and
- The agreement will end at the Maturity Date for each Class of Units.

24. 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 Investment Loan due on the Issue Date and subsequent Investment Loan Interest Payment Dates. The Interest Loan is repayable by monthly in arrears principal and interest payments over the prepaid interest period on the Investment Loan and is limited to a period of twelve months; the interest is fixed for this period. The term of the Interest Loan cannot be extended and the indicative interest rate for an Interest Loan for the first interest period will be available in the relevant Term Sheet.

25. 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.

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

27. Where Investors take out an Interest Loan, they will be advanced the amount of the Loan Establishment Fee (if applicable) as part of the first Interest Loan and that Loan Establishment Fee is payable by monthly repayments over the first year of the investment. These additional payments will be direct debited from an Investor's nominated bank account.

## Put Option

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

## Assumptions

29. 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 that an Investor incurs in connection with this investment
- (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 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 the 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, thereby satisfying the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936, and
- (h) the Investors will not enter into the scheme with the intention to terminate or partially terminate their participation in the scheme early.

## Appendix 1 – Explanation

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

### Section 8-1 and Division 247

30. 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. The assessable income from their investments is expected to be in excess of the expenditure Investors incur in connection with the investment. However, the ability to claim interest deductions may be subject to Division 247.

31. 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.

32. Subsection 247-10(2) states:

That protection is called **capital protection**.

33. Where an Investor enters into an 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, if applicable, that the Investor acquires under the Loan and Put Option Agreement.

34. However, under clause 2.1 of the Loan and Put Option Agreement in the Information Memorandum dated 3 April 2015, 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 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.

35. Where Units are redeemed by the Investor at Maturity, the limited recourse aspect of the Investment Loan means that the amount payable by the Investor to the Loan Provider is limited to the proceeds of the redeemed Units (section 5.1.1 of the Information Memorandum dated 3 April 2015). Clause 10 of the Loan and Put Option Agreement in the Information Memorandum dated 3 April 2015 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 ...

36. Where an Investor takes out an Investment Loan, that Investor may be granted Put Options by the Loan Provider in consideration for the Investor's promise to pay the Put Option Premium pursuant to clause 1.4 of the Loan and Put Option Agreement in the Information Memorandum dated 3 April 2015. The cost of capital protection associated with acquiring the Put Options is not deductible for tax purposes.

37. Clause 5 of the Loan & Put Option Agreement in the Information Memorandum dated 3 April 2015 states that 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).

38. Clause 5(c) of the Loan & Put Option Agreement states that the Loan Provider may set-off the Outstanding Money in relation to each Loan against the Sale Price of the Put Property payable by the Loan Provider to the Investor where an Investor exercises a Put Option on the Put Option Exercise Date. As such the Put Option arrangements provide some form of capital protection to Investors.

39. 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.

40. An Interest Loan can only be taken out by an Investor on a full recourse basis. Section 5.2.1 of the Information Memorandum dated 3 April 2015 confirms the full recourse nature of this type of loan. There is no element of capital protection connected with this type of loan.

41. As the Interest Loan is issued on a full recourse basis, the Investor will need to use their own funds to cover any shortfall (including any break costs), that is associated with this loan.

42. 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)).

43. Under the scheme, the amount reasonably attributable to the cost of capital protection afforded by the limited recourse provisions of the Investment Loan is worked out according to the method statement in subsection 247-20(3) as set out in subparagraph 15(c) of this Ruling. This amount is treated as the cost of the Investor's Put Option under subsection 247-20(6).

44. 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 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**

45. 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 notwithstanding the inclusion of any net capital gain in the Investor's assessable income, section 51AAA of the ITAA 1936 has no application to an Investor.

#### **Section 82KL**

46. 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**

47. 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**

48. 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**

49. 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 making available an amount of 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**

50. 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.

51. 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.

52. 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 prepaid interest deductible under section 8-1 of the ITAA 1997 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.

53. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 54 to 59 of this Ruling.

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

54. 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.

55. 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.

56. 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**

57. 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.

58. 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.

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

## **Division 110 – cost base of the Put Options**

60. Where the Walk Away feature applies, 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)).

61. 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 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.

62. 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**

63. The Investment Loan is a commercial debt under section 245-10.

64. Where the limited recourse provisions of the 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).

65. 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.

66. 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 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.

67. The value of the 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.

68. Under subsection 245-60(1), the value of the 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.

69. The Investment Loan is a 'money lending 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.

70. 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.

71. Therefore, as the value of the 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)).

72. 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 Investment Loan come into effect.

### **Subsection 159GP(1) – a Unit in the Fund is not a ‘security’**

73. 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, that contract is found to be debt like (see paragraphs 4(ii) and 34 to 39 of Taxation Ruling TR 96/14).

74. A Unit in the Fund is not considered to be a contract between the Responsible Entity and the Investor (as a Unit holder), nor are the obligations between the Responsible Entity and the Investor 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**

75. 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**

76. 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 16 to 29 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**

77. 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; TR 96/14

*Subject references:*

- capital protected borrowing
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- tax administration

*Legislative references:*

- ITAA 1936 51(1)
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- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL(1)
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