

PR 2018/3 - Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment plus (2018 Product Brochure)



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This document has changed over time. This is a consolidated version of the ruling which was published on *21 August 2019*



Product Ruling

Income tax: tax consequences of investing in equities using the Macquarie Geared Equities Investment plus (2018 Product Brochure)

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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) that applied for the Product Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Product Ruling.

What this Ruling is about

1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling section apply to the defined class of entities that take part in the scheme to which this Product Ruling relates. All legislative references in this Product Ruling are to the *Income Tax Assessment Act 1997* (ITAA 1997) unless otherwise indicated.

2. In this Product Ruling the scheme is referred to as Macquarie Geared Equities Investment plus (GEI plus loan) which is a loan offered by Macquarie Bank Limited (the Bank) to acquire Approved Securities, or a portfolio of Approved Securities, including securities listed on the Australian Securities Exchange (ASX) and units in registered managed investment schemes (GEI Securities) under the GEI plus Product Brochure dated 13 February 2018 (Product Brochure). In this Product Ruling a reference to GEI Securities includes a reference to a portfolio of GEI Securities.

3. This Product Ruling does not deal with the tax consequences of:

- a GEI plus loan advanced against GEI Securities
- rolling the GEI Securities into a new GEI plus loan for another term, or
- the Limited Trading feature,

which are available under the terms of the scheme and described in the Product Brochure.

4. Interest deductions under section 8-1 for the amount referred to in subparagraph 17(d) of this Product Ruling are available to the Investor up to the time that the Investor uses one or more of the features listed in paragraph 3 of this Product Ruling.

5. This Product Ruling also does not address:

- an Investor's entitlement to franking credits
- the assessability of any dividends or trust distributions received, or entitled to be received, by an Investor in respect of their GEI Securities

- the tax consequences of a refund of prepaid interest in accordance with clause 4.6 of the Loan and Security Agreement
- the tax consequences of any expenditure incurred as a result of extending the Final Maturity Date in accordance with the definition in clause 25.18 of the Loan and Security Agreement
- the tax consequences of acquiring a GEI plus loan in respect of Approved Securities that an Investor already holds and offers as security for the loan, for other investment purposes
- whether the GEI plus loan constitutes a financial arrangement for the purposes of Division 230 (Taxation of financial arrangements)
- the tax consequences of an early termination of the GEI plus loan upon the occurrence of an Event of Default or at the Investor's request, and
- the tax consequences of any transactions entered into as a result of a corporate action, or otherwise involving the transfer of GEI Securities to and from the Nominee.

Class of entities

6. 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.

7. The class of entities who can rely on this Product Ruling consists of those entities:

- that enter into the scheme described in paragraphs 18 to 22 of this Product Ruling and execute relevant Agreements mentioned in paragraph 18 of this Product Ruling on or after 13 February 2018 and on or before 30 June 2020,

and, at the time of entering into the scheme,

- they must have a genuine intention of holding their GEI Securities until such time as they derive assessable income (other than capital gains) from the investment that exceeds the deductible expenditure.

These entities are referred to as Investor/s.

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

- do not hold their GEI Securities for the full term, or that otherwise do not have a genuine intention of holding their GEI Securities until such time as they derive assessable income (other than capital gains) from the investment that exceeds their deductible expenditure
- hold GEI Securities that are non-income producing
- are accepted to participate into the scheme before 13 February 2018 or after 30 June 2020
- participate in the scheme through offers made other than through the Product Brochure, or enter into an undisclosed arrangement with the promoter or a promoter associate, or an independent adviser that is interdependent with scheme obligations and/or scheme benefits (which may include tax benefits) in any way
- have their GEI plus loan advanced against GEI Securities
- fail to give the required instructions regarding which GEI Securities to acquire such that clause 1.4(e) of the Loan and Security Agreement is activated and the Facility is terminated
- are not both the Owner and Borrower as defined in clause 25.18 of the Loan and Security Agreement, 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

9. 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

10. 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 18 to 22 of this Product Ruling.

11. 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

12. This Product Ruling applies prospectively from 13 February 2018. It therefore applies only to the specified class of entities that enter into the scheme from 13 February 2018 until 30 June 2020, 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.

13. However, this Product Ruling only applies to the extent that there is no change in the scheme or in the entity's involvement in the scheme.

Changes in the law

14. 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.

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

Note to promoters and advisers

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

Ruling

17. Subject to paragraphs 3, 4 and 5 of this Product Ruling, and the assumptions in paragraph 22 of this Product Ruling:

- (a) In relation to the GEI plus loan, Division 247 will apply to treat the excess (if any) calculated under the method statement in subsection 247-20(3) as being reasonably attributable to the cost of capital protection for the income year.
- (b) Under subsection 247-20(3), the amount reasonably attributable to the cost of capital protection under Division 247 in an income year is the amount by which the expense incurred for interest on the GEI plus loan exceeds
 - where the interest rate charged by the Bank is a fixed rate for all or part of the term of the loan and that fixed rate is applicable to the loan for all or part of the income year, the amount of the loan multiplied by the sum of the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Loans – Investor and 100 basis points (the 'adjusted loan rate') at the time when the interest charge is first incurred during the term of the loan, or the relevant part of the term (subsections 247-20(4) and (5)), and
 - where the interest rate charged by the Bank is a variable rate for all or part of the term of the loan and a variable rate is applicable to the loan for all or part of the income year, the amount of the loan multiplied by the average of the adjusted loan rates applicable during those parts of the income year when the loan is at a variable rate (subsections 247-20(5) and (5A)).
- (c) The amount reasonably attributable to the cost of capital protection under Division 247, as worked out under subparagraph 17(b) of this Product Ruling, is treated as the cost of 'deemed' put options (Put Options) granted by the Bank to the Investor under subsection 247-20(6). This amount is not deductible under section 8-1.
- (d) An amount equal to the expense incurred for interest on the GEI plus loan reduced by the cost of the Put Options will be deductible under section 8-1.
- (e) An amount equal to the expense incurred for interest on the Interest Prepayment Loan will be deductible under section 8-1. Division 247 will not apply to this loan.

- (f) Section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny deductibility of the interest incurred under the GEI plus loan and the Interest Prepayment Loan (if applicable) that is allowable as a deduction under section 8-1.
- (g) Section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest incurred under the GEI plus loan or the Interest Prepayment Loan (if applicable) that is allowable as a deduction under section 8-1.
- (h) Section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for any prepaid interest incurred under the GEI plus loan that is allowable as a deduction under section 8-1.
- (i) Section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility of any part of any prepaid interest incurred on the GEI plus loan that is allowable as a deduction under section 8-1, 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), that has not chosen to apply section 82KZMD of the ITAA 1936 to the expenditure, or
 - the Investor is an individual who does not incur the interest charge in carrying on a business.
- (j) Sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for any prepaid interest incurred under a GEI plus loan that is allowable as a deduction under section 8-1 to an Investor (other than a small business entity that has not chosen to apply section 82KZMD to the expenditure) that is a taxpayer that is not an individual and does not carry on a business.
- (k) If an Investor does not exercise a Put Option by the relevant date, the Put Option will expire (subsection 247-30(2)). The proportion of the total cost of the Put Options that is reasonably attributable to that Put Option 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.
- (l) Capital Gains Tax (CGT) Event C2 will happen under section 104-25 if a Put Option is not exercised by the Final Maturity Date and expires. An Investor will make a capital loss that is equal to the reduced cost base of that Put Option.

- (m) If an Investor exercises a Put Option in relation to a GEI Security at the end of the GEI plus loan term, the cost of the Put Option will be included in the second element of the cost base and the reduced cost base of that GEI Security pursuant to item 2 of the table in subsection 134-1(1). Any capital gain or capital loss the Investor makes from exercising a Put Option will be disregarded under subsection 134-1(4).
- (n) If an Investor repays the GEI plus loan and sells GEI Securities to fund the repayment, CGT event A1 will happen under section 104-10. The Investor will make a capital gain on selling the GEI Securities equal to the capital proceeds less the cost base of the GEI Securities.
- (o) The Loan Establishment Fee paid by an Investor is deductible under section 25-25 (if applicable).
- (p) The anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny the deductibility of the interest or the Loan Establishment Fee incurred by the Investor in respect of borrowings under a GEI plus loan or the Interest Prepayment Loan (if applicable).
- (q) None of the taxation consequences set out in subparagraphs 17(a) to 17(p) of this Product Ruling will change as a consequence of the execution of the terms and conditions of the Portfolio Asset Novation Agreement (the Novation Agreement), nor will the execution of the terms and conditions of the Novation Agreement give rise to any CGT event for the Investor under Division 104.
- (r) If, from the GEI Completion Date, an Investor redeems their units in an approved Cash Trust offered by the Bank for the purpose of investing the proceeds of that redemption into the Bell Cash Trust, CGT event C2 will happen under section 104-25. The Investor will make a capital gain if the proceeds of the redemption are more than the cost base of the units, or a capital loss if the proceeds of redemption are less than the reduced cost base of the units.

Scheme

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

- application for a Product Ruling as constituted by documents and information received on 31 October 2017, 2 November 2017, 6 February 2018,

20 May 2019, 23 May 2019, 27 May 2019,
11 July 2019 and 26 July 2019

- GEI plus Product Brochure dated 13 February 2018, including the Loan and Security Agreement and Interest Prepayment Loan Agreement
- GEI plus Supplementary Product Brochure dated 24 May 2019
- GEI plus Application Form dated 13 February 2018 and, as amended, 24 May 2019, and
- Portfolio Asset Novation Agreement dated 23 May 2019 between the Bank and Bell Potter Capital Limited (BPC).

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

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

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

Overview

21. Following is a summary of the scheme:

- (a) Under the scheme, Investors borrow funds from the Bank to finance the purchase of GEI Securities (including a portfolio of GEI Securities). The GEI Securities are shares, units in certain widely held trusts and/or stapled securities listed on the ASX, or units in trusts that are managed investment schemes, as defined in section 9 of the *Corporations Act 2001*, and that are registered under section 601EB of that Act including units in an approved Cash Trust. Where the GEI Security is a stapled security, the stapled security comprises share/s and unit/s that are jointly listed for quotation on the ASX.
- (b) The Investors are required to select GEI Securities or a portfolio of GEI Securities from an approved list of GEI Securities which is available on the GEI plus website, up to the amount of funds borrowed from the Bank. The minimum loan amount is \$50,000.

- (c) An Investor may select their own combination of GEI Securities to form a portfolio but no more than 50% of the value of the portfolio of GEI Securities selected by the Investor may consist of units in a managed investment scheme (including units in an approved Cash Trust). An approved Cash Trust means a managed investment scheme which invests in short-term cash deposits, short-term money market and floating rate securities, annuities and cash equivalent securities issued by entities (including, potentially, the Bank), as determined by the Bank from time to time.
- (d) At the Investor's option, the term of the GEI plus loan may be one, two, three or four years. Interest is payable monthly in arrears on a variable basis. Alternatively, Investors may fix their interest rate for one or more years and pay interest annually in advance for a 12 month period.
- (e) The Bank will calculate a different rate of interest for each GEI Security an Investor may invest in. The interest rate will be quoted and reported to an Investor as a single consolidated rate taking into account all of the GEI Securities held. The interest rate will also depend upon the term of the GEI plus loan. Generally, the shorter the period of the GEI plus loan and the greater the risk to the Bank given the security offered by the GEI Securities, the higher the rate of interest charged. The inclusion in the portfolio of GEI Securities of units in an approved Cash Trust is likely to result in a lower interest rate on the GEI plus loan compared to a portfolio of GEI Securities which does not include units in an approved Cash Trust.
- (f) Investors may also choose to enter into an Interest Prepayment Loan with the Bank for the purpose of funding the payment of prepaid interest on a GEI plus loan. The term of each Interest Prepayment Loan starts on the day interest is payable for an Interest Period on the GEI plus loan and ends on the last day of that Interest Period, and will not exceed 12 months. The interest rate on an Interest Prepayment Loan will be determined by the Bank at the time of drawdown of the particular Interest Prepayment Loan. The Interest Prepayment Loan is repayable by way of monthly in arrears principal and interest repayments over the prepaid interest period on the GEI plus loan immediately succeeding the date the Interest Prepayment Loan is borrowed. Under the Interest Prepayment Loan there is no limitation on the recourse of the Bank. Repayment of the Interest Prepayment Loan prior to its maturity date may incur break costs.

- (g) A Loan Establishment Fee of up to 3% of the GEI plus loan may be charged by the Bank at its discretion, and is payable in full on each day of making a Drawing. Where a Loan Establishment Fee is charged this will generally result in a lower interest rate on the GEI plus loan than if the Loan Establishment Fee had not been charged.
- (h) For the purpose of securing the rights of the Bank under the scheme, the Investor, as legal and beneficial owner (or where the Investor is a trustee of a trust, as legal owner) of the GEI Securities, grants a mortgage to the Bank over the acquired GEI Securities and related rights.
- (i) The Loan and Security Agreement provides for a limited recourse facility by the Bank in relation to the Investor. As such, the Bank is only entitled to enforce its rights as mortgagee in relation to the principal of the GEI plus loan against the GEI Securities held as security.
- (j) The limited recourse loan facility operates to limit the Investor's liability under the loan facility to the GEI Securities and operates as a mechanism of capital protection. If requested to do so by the Investor, the Bank will exercise its rights under the mortgage facility at the Final Maturity Date where the market value of the Investor's GEI Securities (or of one or more types of GEI Securities) has fallen below the acquisition cost of those GEI Securities. The Bank is entitled to set-off the payment of that price against the obligations of the Investor to repay the GEI plus loan in respect of the GEI Securities (or the type(s) of GEI Securities). The Investor will have no further obligation to the Bank in respect of the GEI plus loan (or the portion of the GEI plus loan in respect of the respective type(s) of GEI Securities).
- (k) The Investor is not required to pay a separate fee for the limited recourse loan facility.
- (l) The Investor shall repay the outstanding portion of the GEI plus loan to the Bank in one amount on the Final Maturity Date. At least five clear Business Days before the Final Maturity Date, the Investor must inform the Bank whether
 - (i) the Investor will repay all or part of the GEI plus loan on the Final Maturity Date, and/or
 - (ii) the Investor intends to activate the limited recourse loan facility, and/or

- (iii) the Investor intends to refinance the scheme and extend the term of all or part of their GEI plus loan.
- (m) Any ordinary dividends or trust distributions paid in respect of the GEI Securities acquired under the scheme are paid to the Investor, although in some circumstances, the Investor may be required to reinvest the distributions to acquire further GEI Securities of the same type.
- (n) Any further securities acquired or bonus securities issued will form part of the security for the GEI plus loan. At the expiry of the GEI plus loan, should the market value of the original securities, and any bonus or further securities, be below the cost of the original parcel of GEI Securities, the original plus any bonus or further securities may be subject to the limited recourse loan facility.
- (o) On, and subject to, the terms and conditions of the Novation Agreement:
 - (i) the Bank has agreed to novate to BPC (or a Related Body Corporate of BPC) all of the right, title, interest and benefit of a Macquarie Group Member under or in connection with the GEI Arrangements entered into with an Investor, as at the date on which the completion of the novation occurs (the GEI Completion Date, being 5 August 2019), and
 - (ii) BPC has agreed, as at the GEI Completion Date, to assume all liabilities of each Macquarie Group Member related to the GEI Arrangements entered into with an Investor, and discharge them as and when they fall due.
- (p) As a consequence of the execution of the Novation Agreement, as and from the GEI Completion Date:
 - (i) BPC shall be substituted for the Bank under each GEI Arrangement as if BPC had originally been a party to each GEI Arrangement instead of the Bank on the terms of the Product Brochure, and
 - (ii) the Bell Cash Trust will be added as an approved Cash Trust to the approved list of GEI Securities available for selection, and offered as an alternative to the approved Cash Trust offered for selection as a GEI Security by the Bank.

Assumptions

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

- (a) all of the Investors are Australian residents for taxation purposes
- (b) the Investors are not traders in investments and are not treated for taxation purposes as trading in the GEI Securities, carrying on a business of investing in the GEI Securities, or holding GEI Securities as trading stock or as revenue assets
- (c) in respect of any interest charges to be paid in advance under the GEI plus loan, these may be prepaid only in relation to a loan interest payment period of 12 months or less and which ends on or before the last day of the income year following the expenditure year
- (d) at the time of any interest prepayment, where the GEI Securities include units in a trust, the trust satisfies the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936
- (e) where the GEI Securities acquired by an Investor include units in a trust, it is reasonable to expect that the Investor will derive trust income from those units
- (f) the dominant purpose of an Investor in entering the scheme is to derive an amount of receipts (income, gains and distributions) from their GEI Securities acquired under the scheme that exceeds the total expenses incurred in respect of the GEI plus loan
- (g) the scheme will be executed in the manner described in the Scheme section of this Ruling and in accordance with the scheme documentation mentioned in paragraph 18 of this Ruling, and
- (h) all dealings by the Investors, the Bank and BPC under the scheme will be at arm's length.

Commissioner of Taxation14 February 2018

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

23. Interest paid on a borrowing used to acquire income producing assets such as shares or units is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (refer to Taxation Ruling TR 95/33 *Income tax: subsection 51(1) – relevance of subjective purpose, motive or intention in determining the deductibility of losses and outgoings*). However, the ability to claim interest deductions may be subject to Division 247.

24. 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.

25. Subsection 247-10(2) states:

That protection is called **capital protection**.

26. Under the scheme, the amount reasonably attributable to the cost of capital protection afforded by the limited recourse loan facility is worked out according to the method statement in subsection 247-20(3) as set out in subparagraph 17(b) of this Product Ruling. This amount is treated as the cost of the Investor's Put Options under subsection 247-20(6).

27. For an Investor in the scheme, a Put Option is a capital asset. As the cost of capital protection is the cost of the Investor's Put Options, this expense is capital in nature. The interest charged on the GEI plus loan will be deductible under section 8-1 only to the extent that it does not constitute the cost of capital protection.

28. Under the arrangement where an Investor chooses to enter into a full recourse Interest Prepayment Loan in addition to a limited recourse GEI plus loan, only the borrowing under the limited recourse GEI plus loan is considered to be subject to capital protection.

29. An Interest Prepayment Loan can only be taken out by an Investor on a full recourse basis. There is no element of capital protection connected with this type of loan.

30. The Bank is entitled to apply the proceeds from the sale of an Investor's GEI Securities to effectively meet all outstanding loan amounts of the Investor on the Final Maturity Date. However, as the Interest Prepayment 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.

Section 51AAA

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

Section 82KL

32. 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.

Subdivision H of Division 3 of Part III

33. 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 arrangement 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 that are of a capital nature.

Subdivision 328-C – small business entities for the purposes of Subdivision H

34. 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 \$10 million

- (b) the aggregated turnover for the current year is likely to be less than \$10 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 \$10 million, or
- (c) the aggregated turnover for the current year, worked out as at the end of the year is less than \$10 million.

The eligible service period for the purposes of Subdivision H

35. The interest charge under the GEI plus loan that is deductible under section 8-1 may be 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 and not to the period of the loan.

Sections 82KZME and 82KZMF – prepaid expenditure and 'tax shelter' style arrangements

36. The rules in sections 82KZME and 82KZMF of the ITAA 1936 apply, subject to the exceptions in section 82KZME, where expenditure is incurred in relation to a 'tax shelter' style arrangement for the doing of a thing that is not to be wholly done within the expenditure year.

37. For the purposes of section 82KZME of the ITAA 1936, 'agreements' are broadly defined to include an entire arrangement of which a contract may form part. Under subsection 82KZME(4), the relevant 'agreement' is all the contractual arrangements and activities associated with the participation in the scheme, including the financing, share and/or unit purchase, share and/or unit holding and disposal arrangements.

38. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the amount of interest allowable as a deduction under section 8-1 on borrowings under the GEI plus loan from the operation of section 82KZMF of the ITAA 1936, as:

- the prepaid interest expenditure under the GEI plus loan is incurred in respect of money borrowed to acquire GEI Securities that are listed for quotation on the ASX or units in a trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936

- the Investor can reasonably be expected to obtain dividends and/or trust income from the investment
- the Investor will not obtain any other kind of assessable income from the investment, except for capital gains, and
- all aspects of the scheme are at arm's length.

39. Deductibility of the prepaid interest must therefore be considered under the prepayment rules contained in paragraphs 40 to 45 of this Product Ruling.

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

40. 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
- an individual and the expenditure is not incurred in carrying on a business.

41. 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.

42. As the eligible service period in relation to the deductible interest payments for the GEI plus loan is not more than 12 months and does not end after the last day of the year of income after the one in which the expenditure was incurred, section 82KZM of the ITAA 1936 will have no application to Investors that are a small business entity that has not chosen to apply section 82KZMD of the ITAA 1936 to the expenditure for the year of income, or to Investors who are individuals and the expenditure is not incurred in carrying on a business. Investors that satisfy these tests will be able to claim an immediate deduction for the interest amount incurred on the GEI plus loan that is allowable as a deduction under section 8-1.

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

43. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for an Investor (other than a small business entity 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.

44. The expenditure must not be excluded expenditure and must be incurred in return for the doing of a thing under an agreement that is not to be wholly done within the expenditure year.

45. For these Investors, the amount of prepaid interest incurred on the GEI plus loan and allowable as a deduction under section 8-1 will be apportioned over the relevant interest payment period.

Division 110 – cost base of the Put Options

46. The cost of capital protection is not deductible to the Investor under section 8-1 (refer to subparagraph 17(c) of this Product Ruling) and is included in the first element of the cost base (under subsection 110-25(2)) and the reduced cost base (under subsection 110-55(2)) of a Put Option acquired by the Investor. Each Put Option constitutes a CGT asset, and is separate and in addition to the other rights created under the scheme as described in this Ruling.

47. As a single interest rate applies in respect of the GEI plus loan, including where more than one type of GEI Security is held, the investment will be treated as one arrangement for the purposes of Division 247. As capital protection may be invoked in respect of each type of GEI security a separate Put Option is deemed to be provided in respect of each type of GEI Security acquired with the GEI plus loan. The cost of capital protection will therefore need to be reasonably apportioned to each Put Option. The proportion of the cost of capital protection that is reasonably attributable to each Put Option is the cost of each type of GEI Security acquired with the GEI plus loan divided by the cost of all of the GEI Securities acquired with the GEI plus loan, multiplied by the cost of capital protection.

48. If the Investor exercises a Put Option at the end of the GEI plus loan term by relying on the limited recourse provisions of the loan in relation to a type of GEI Security, the Investor will include the payment they are deemed to have made to acquire the Put Option in the second element of the Investor's cost base and reduced cost base of the GEI Security disposed of by the Bank (on behalf of the Investor) under its rights as mortgagee, pursuant to item 2 of the table in subsection 134-1(1). Any capital gain or capital loss the Investor makes from exercising a Put Option is disregarded under subsection 134-1(4).

49. Although the sale proceeds will be insufficient to repay the GEI plus loan, the Bank will have no recourse against the Investor to recover the shortfall. In this circumstance, the Investor will need to reduce the cost base (under subsection 110-45(3)) and the reduced cost base (under subsection 110-55(6)) of the GEI Security by the amount of the shortfall. The combined effect will be to give rise to a capital loss equal to, at the very least, the cost base of the Put Option.

50. If the Investor does not exercise a Put Option by the Maturity Date, the Put Option will be taken to have expired under subsection 247-30(2). This will cause CGT event C2 to happen pursuant to paragraph 104-25(1)(c). The Investor will make a capital loss at that time, equal to the reduced cost base of the Put Option. This would occur where:

- (a) the Investor sold the GEI Securities and repaid the GEI plus loan at the Final Maturity Date, where the capital proceeds were higher than the balance of the GEI plus loan – this would also cause CGT event A1 to happen to the GEI Securities under section 104-10, or
- (b) the Investor repaid the GEI plus loan at the Final Maturity Date, whether from other existing funds or by refinancing the GEI Securities, so that the Investor could retain ownership of the GEI Securities.

Section 25-25 – Loan Establishment Fee

51. The Loan Establishment Fee, if applicable, incurred by an Investor upon successful application for the GEI plus 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 term of the GEI plus loan.

Part IVA – anti avoidance

52. 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 18 to 22 of this Product Ruling), it is accepted that the scheme is an ordinary commercial transaction and Part IVA of the ITAA 1936 will not apply.

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Not previously issued as a draft

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TR 95/33

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NO: 1-D2LVWQZ

ISSN: 2205-6114

BSL: PGH

ATOlaw topic: Income tax ~~ Financial arrangements ~~ Other

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