TD 2005/4 - Income tax: section 8-1 of the Income Tax Assessment Act 1997: refinancing a capital protected loan facility: interest deductibility

Taxation Determination

Income tax: section 8-1 of the *Income Tax Assessment Act 1997*: refinancing a capital protected loan facility: interest deductibility

Preamble

The number, subject heading, date of effect and paragraphs 5 to paragraphs 8 of this document are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner.*

On 16 April 2003 the Treasurer announced amendments to the Income Tax Assessment Act 1997 to ensure part of the expense of a capital protected product is attributed to the cost of the capital protection feature. The expense is apportioned in accordance with the guidelines (interim methodology) announced by the Minister for Revenue and Assistant Treasurer on 30 May 2003 in the press release 'Taxation of Capital Protected Products'.

This Taxation Determination relates to that part of the interest expense that is available for a deduction in accordance with the interim methodology and is referred to in this Taxation Determination as 'Interest'.

Background

1. A capital protected loan facility is a fixed term loan used to purchase shares or other securities listed on the Australian Stock Exchange (referred to as shares in this Taxation Determination). Typically, a capital protected loan will either be a limited recourse loan or a full recourse loan, together with a put option. The capital protected feature means that the investor is effectively protected from the risk of a fall in the price of the shares as the associated put option enables the borrower to require the lender to take the shares in full repayment of the outstanding principal.

2. Interest is payable on the capital protected loan facility. Typically interest will either be payable annually in advance or monthly in arrears.[1]

3. At the conclusion of the capital protected loan term, the investor may have the opportunity to use a '*refinancing feature*'. A refinancing feature will generally allow an investor to extend the term of the capital protected loan or to 'roll-over' into another loan facility, for example another capital protected loan or a margin loan.

[1] Where interest is paid in advance the prepayment provisions in Subdivision H of Division 3 of Part III of the *Income Tax Assessment Act 1936* will need to be considered.

4. If a capital protected loan is 'rolled-over' into another loan facility, the 'new loan amount' may reflect the current value of the underlying shares. For example: if the shares' value has increased, the new loan amount may be set at the increased market value of the shares. The funds from the refinancing loan are first applied against the original capital protected loan and the excess amount representing the increased value is paid to the investor.

Determination

Drawdown of the capital protected loan facility

5. When the capital protected loan is first drawn down and the proceeds are used to acquire shares that are expected to produce dividends, the necessary nexus with the assessable income exists for the Interest outgoings to be deductible under section 8-1 of the *Income Tax Assessment Act 1997*.

Refinancing

6. A deduction will be allowable under section 8-1 for Interest outgoings incurred in respect of refinancing an existing capital protected loan provided that the whole of the new loan amount is used for income producing purposes.

7. Refinancing does not of itself break the nexus between the Interest outgoings and the income producing activity. When an original borrowing is refinanced, the new borrowing takes on the same character as the original borrowing. To the extent that Interest outgoings in respect of the capital protected loan are deductible, Interest outgoings will generally be deductible in respect of the new borrowings.

8. However, where an investor receives loan funds greater than the amount needed to repay the capital protected loan facility, the deductibility of Interest outgoings in respect of those surplus funds will depend on whether the Interest outgoings are incurred in gaining or producing assessable income. The Interest outgoings will be deductible under section 8-1 to the extent that the surplus loan funds are used for income producing activities. If, for example, an investor uses the additional loan funds to acquire further shares, the necessary nexus will exist and Interest outgoings will be deductible under section 8-1. Where the new loan funds in excess of the amount required to pay out the original loan are not invested in an income producing activity, no deduction in respect of the interest expense attributable to the excess borrowed funds is allowable under section 8-1.

Date of Effect

9. This Determination applies to years commencing both before and after its date of issue. However, it does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Commissioner of Taxation
30 March 2005

Previous draft:

TD 2004/D86

Related Rulings/Determinations:

TR 92/20

Subject references:

- capital protected loan facility
- capital protected product
- interest deductibility
- limited recourse loan
- refinancing feature

Legislative references:

- TAA 1953 Pt IVAAA
- ITAA 1997 8-1
- ITAA 1936 Pt III Div 3 Subdiv H

ATO references

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