



TD 2005/6 - Income tax: section 8-1 of the Income Tax Assessment Act 1997: capital protected loan facility with a trading feature: interest deductibility

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Taxation Determination

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

Preamble

*The number, subject heading, date of effect and paragraphs 6 to paragraphs 10 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

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.

3. Under a capital protected loan facility the investor may have the opportunity to use a 'trading feature'. A trading feature allows an investor to sell the underlying shares without terminating the loan facility.² Generally, the proceeds from sale of the shares are placed in an income producing investment held as security for the obligations under the facility until such time as the investor acquires further shares.

4. An investor may use the proceeds of sale to re-acquire either the same number and kind of shares originally held in a company or companies or to acquire shares in a different company or companies with a value equal to the original loan amount. Where the proceeds of sale of the original shares are greater than the amount used to acquire further shares, the investor is able to withdraw the surplus amount from the income producing investment. Where the proceeds of sale are less than the amount used to acquire further shares, the investor must contribute the amount of the shortfall.

5. If the investor elects to re-acquire the same number and kind of shares originally held, the terms of the capital protected loan will remain the same, albeit that the loan amount may change. If the investor elects to acquire different shares equal in value to the amount of the loan, the original put option will generally be terminated and a new put option is granted in respect of the newly acquired shares.

Determination

Drawdown of the capital protected loan facility

6. 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*.

Trading shares

7. Where an investor subsequently sells the shares as a result of using the trading feature it is necessary to determine whether the occasion of the Interest outgoing continues to be found in an income producing activity. The application of the proceeds of sale equivalent to the original loan amount to another income producing purpose will demonstrate the necessary connection between the Interest outgoings and a continuing income producing activity.

8. Accordingly, where proceeds equivalent to the original loan amount are used to acquire further shares or remain in an income producing investment, there is no relevant change in the income producing purpose and the connection between the Interest outgoing and the income producing activity continues. Consequently, the Interest outgoings will continue to be deductible under section 8-1.

9. Where the use of the borrowed funds has changed and they are no longer used for income producing purposes, Interest on the loan ceases to be deductible.

10. Should the capital protected loan arrangements allow proceeds to be withdrawn from the facility such that the amount reinvested in shares or in an income producing investment is less than the amount borrowed, there is a change in the use of the funds to that extent. Consequently, the Interest outgoings will need to be apportioned.

² Acquisition of the shares on capital account will not necessarily mean that a subsequent disposal is on capital account. This will depend on the facts and circumstances relevant to each investor.

Date of Effect

11. 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 Taxation30 March 2005

Previous draft:

TD 2004/D88

- interest deductibility
- limited recourse loan
- trading feature

Related Rulings/Determinations:

TR 92/20

*Legislative references:**Subject references:*

- capital protected loan facility
- capital protected product

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

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