



PR 2001/163 - Income tax: deductibility of interest incurred on borrowings under the UBS Protected Equity Product

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Product Ruling

Income tax: deductibility of interest incurred on borrowings under the UBS Protected Equity Product

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Potential participants may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons and Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the Taxation Administration Act 1953. Product Ruling PR1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

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

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product. Further, we give 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.

Participants must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for participants by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, participants lose the protection of this Product Ruling. Participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Participants should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the 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 Ruling.

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' identified below apply to the defined class of persons who take part in the arrangement to which this Ruling relates. In this Ruling the arrangement is the grant of a Put Option and the borrowing of moneys from UBS AG, Australia Branch ('UBS') to fund the acquisition of shares on the terms of a lending and share investment facility named the 'UBS Protected Equity Product' which is referred to in this Ruling as 'the PEP'.

Tax law(s)

2. The tax laws dealt with in this Ruling are:
- section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
 - section 51AAA of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KL of ITAA 1936;
 - section 82KZM of ITAA 1936;
 - sections 82KZMA, 82KZMB and 82KZMC of ITAA 1936;
 - sections 82KZME, 82KZMF of ITAA 1936;
 - section 110-25(2) of ITAA 1997; and
 - Part IVA of ITAA 1936.

Class of persons

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed and of deriving assessable income from their involvement as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Investors'.

Qualifications

4. The Commissioner rules on the precise arrangement identified in the Ruling.

5. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

7. This Ruling applies prospectively from 19 December 2001, the date this Ruling is made. However, the Ruling 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 issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

8. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, this Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

9. This Product Ruling is withdrawn and ceases to have effect after 31 December 2004. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no material difference in the arrangement or in the persons' involvement in the arrangement.

Arrangement

10. The arrangement that is the subject of this Ruling is described below. This description incorporates the following documents:

- Application for a Product Ruling dated 25 May 2001 and letters dated 31 August 2001, 10 September 2001, 28 November 2001 and 29 November 2001, received from Blake Dawson Waldron on behalf of UBS;
- Information Memorandum for the Protected Equity Product (the "Information Memorandum") prepared and issued by UBS, draft dated 25 May 2001;
- UBS Protected Equity Product Loan and Put Option Agreement (the "Loan Agreement"), draft dated 25 May 2001; and
- Indicative Protected Equity Product Term Sheet for the Australian Bank Basket prepared and issued by UBS (the "Indicative Term Sheet"), draft dated 25 May 2001.

Each Investor will enter into the Loan Agreement with UBS on or after the date of this Ruling.

11. The details and aspects of the arrangement subject to this Ruling are summarised as follows:

- (a) The PEP involves the grant of a Put Option and the making of a loan by UBS to an Investor for a fixed term of three years. The funds provided under the loan are used to finance 100% of the purchase price of a basket of shares (the "Approved Securities") to be acquired by the Investor. UBS will offer Investors a choice of baskets, for example industry specific baskets. In some circumstances the basket of shares comprising the Approved Securities may consist of only one type of Approved Security.
- (b) The loan is segmented into tranches (each tranche separately being a "Loan"). The tranches correspond to the amount applied to purchase each type of Approved Securities in the basket.
- (c) Clause 4.4 of the Loan Agreement provides an Investor with an option ("Put Option") to sell each type of Approved Securities in the basket for the amount outstanding under the Loan which relates to that Approved Security. The Put Option may only be

exercised by the Investor at maturity of the Loan. Each Put Option granted to the Investor may be exercised independently of each other Put Option (for example, if one of the Approved Securities in the basket falls in value, the Investor can exercise their Put Option for that Approved Security, but need not exercise their Put Options for the other Approved Securities in the basket).

- (d) A portion of the interest payments is allocated to the Put Option premium. The Put Option premium is based on the “Put Option Premium Rate”, which is the greater of the excess of the interest rate charged on the Loan above the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans, or 20% of the interest rate.
- (e) The Loan is secured by a mortgage in favour of UBS over the Approved Securities, any dividends paid or payable on the Approved Securities, the Put Option and all other rights in respect of the Approved Securities.
- (f) The Loan by UBS to the Investor is a “limited recourse” loan. Under the terms of the Loan Agreement, UBS’s ability to recover the principal amount of the Loan is limited to either:
 - if the Put Option is exercised by the Investor - the amount payable to the Investor under the Put Option; or
 - if the Put Option is not exercised by the Investor - the amount that UBS is able to obtain by enforcing its rights in respect of the mortgaged property.

In all other respects (for example, payment of interest and break costs) UBS’s recourse against an Investor will not be limited.

- (g) The term of the Loan is three years. Generally speaking, interest on the Loan is payable at or before the start of the relevant interest payment period, for example **annually in advance**. UBS may, however, stipulate that interest may be paid in arrears for one or more of the interest payment periods.
- (h) For each basket of Approved Securities, the interest rate for the first interest payment period will be set out in the applicable term sheet, with the interest payable after the first interest payment period based on market rates at that time.

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- (i) On maturity of the loan, the Investor has four alternatives:
 - (i) repay the Loan from their own funds, (which will result in a release of the mortgage over the Approved Securities);
 - (ii) extend the Loan for a further fixed term (if UBS makes this option available to the Investor) subject to the consent of UBS;
 - (iii) exercise the Put Option; and
 - (iv) if none of the above apply, UBS may proceed to exercise its rights as mortgagee of the mortgaged property, and distribute surplus disposal proceeds, if any, to the Investor after repayment of the Loan and any costs and expenses.
- (j) The Investor may pre-pay the Loan prior to maturity. If this occurs, the Investor may be liable for additional break costs incurred by UBS as a result of the early unwinding of the PEP.
- (k) The Investor must nominate the Approved Securities to be acquired using the proceeds of the Loan on the initial application form by specifying the applicable term sheet. The terms of the Loan Agreement place restrictions on the Investor's ability to trade the Approved Securities during the term of the Loan. Any dividends paid to the Investor in respect of the Approved Securities will be held for the Investor by UBS or its nominee. The Loan Agreement provides that such amounts will be used towards payment of the Investor's interest obligations to UBS. Any dividends remaining after an interest payment date may be released to the Investor.
- (l) At maturity, the Investor may choose to extend the Loan for a further period (if UBS makes this option available to the Investor) subject to UBS's consent. Any extension will not affect the mortgage over the Approved Securities.

The Participants

- 12. UBS is the provider of the Loans to Investors under the PEP to fund the acquisition of the Approved Securities.
- 13. The Investors may be individuals, companies or trusts.

Ruling

14. Subject to the assumptions listed in paragraph 15 of this ruling:
- (a) Part of the 'interest' charged under the PEP is a capital protection fee and is not deductible under section 8-1 of ITAA 1997.
 - (b) The PEP interest charge allowable under section 8-1 of ITAA 1997 is the amount that does not exceed the lower of the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans (as the interest rate charged on a Loan is a variable rate the Reserve Bank Bulletin Indicator Lending Rate for Personal Unsecured Loans-Variable is to be used) or 80% of the total interest charged by UBS under the Loan Agreement.
 - (c) The amount of interest on each Loan that is not deductible under the formula described in paragraph 14(b) represents the consideration paid in instalments by an Investor for the acquisition of the relevant Put Option, and is included in the Investor's cost base for that Put Option under section 110-25(2) of ITAA 1997.
 - (d) Section 51AAA of ITAA 1936 will not apply to deny an Investor a deduction for the PEP interest charge allowable under section 8-1 of ITAA 1997.
 - (e) Section 82KL, a specific anti-avoidance provision of ITAA 1936, will not apply to deny deductibility of the PEP interest charge allowable under section 8-1 of ITAA 1997.
 - (f) Section 82KZM of ITAA 1936 will not apply to deny immediate deductibility for the PEP interest charge incurred during an income year commencing after 30 June 2001 by the Investor and at least one of the following applies for the year of income:
 - the Investor is an STS taxpayer; or
 - the Investor is an individual who does not incur the expenditure in carrying on a business.
 - (g) Sections 82KZMA, 82KZMB and 82KZMC of ITAA 1936 will apply to determine the amount and timing of deductions for the PEP interest charge incurred during an income year commencing after 30 June 2001 where the expenditure is incurred by an Investor (other than an STS taxpayer for the year of income) who either:

- carries on a business; or
 - is a taxpayer that is not an individual and does not carry on a business.
- (h) Section 82KZMF of ITAA 1936 will not apply to set the amount and timing of deductions for the PEP interest charge.
- (i) The anti-avoidance provisions contained in Part IVA of ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor in respect of borrowings used to fund the purchase of Approved Securities.

Assumptions

15. This Ruling is made on the basis of the following assumptions:
- (a) All of the Investors are Australian residents;
 - (b) The Investors are not traders in investments and are not treated for taxation purposes as either trading in the Approved Securities or carrying on a business of investing in the Approved Securities. Further, the Investors do not otherwise hold the Approved Securities as revenue assets;
 - (c) In respect of any interest charges to be paid in advance under the PEP Loan Agreement, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less that ends by the last day of the income year following the expenditure year;
 - (d) The Investors will derive assessable income from the investment in the Approved Securities. That assessable income will be dividends and capital gains;
 - (e) The dominant purpose of an Investor in entering the arrangement is to derive assessable income from their investment in the Approved Securities;
 - (f) The arrangement will be executed in the manner described in the “Arrangement” section of this Ruling;
 - (g) All dealings by Investors and UBS will be at arm’s length; and
 - (h) The Investors will not prepay the loan prior to maturity or terminate the arrangement early.

Explanations

Section 8-1 of ITAA 1997

16. The cost (or interest paid) of a borrowing used to acquire income producing assets such as shares 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 (see Taxation Ruling TR 95/33).

17. The ATO view expressed in media release Nat 99/26 is that part of the 'interest' charged under the PEP is a capital protection fee and is not deductible under section 8-1. The ATO considers that the purpose of this fee is to give the taxpayer capital protection in the event of a share price fall.

18. Investors should only claim deductions equal to the amount of interest determined as follows - the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans – Variable or 80% of the total interest charged by UBS.

19. The ATO is of the view that the part of the interest payments under the Loan allocated to the consideration for the Put Option (being the "Put Option Premium") is a capital protection fee and is not deductible under section 8-1. The ATO view is that the capital protection fee is not deductible because it is incurred for a purpose other than to service or maintain the borrowed funds. The fee is capital in nature, being paid to acquire an asset, namely, the Put Option.

20. The Put Option Premium ensures that the borrower is protected from liability to repay the principal if the market value of a tranche of shares falls below their original purchase price. In effect, the Put Option ensures that UBS will acquire the shares in full satisfaction of the loan amount if the shares have fallen in value below the amount borrowed. Accordingly, the consideration paid for the acquisition of the Put Option is a capital protection fee.

21. That amount which is not deductible to the Investor under section 8-1 forms the cost base of a Put Option and constitutes an asset for capital gains tax purposes which is separate and in addition to the other rights created under the PEP as described in this Ruling.

Section 51AAA of ITAA 1936

22. Under the PEP it is contemplated that over a period of an Investor's involvement there will be assessable income derived by the receipt of dividend income and capital gains. Accordingly, the interest would have been deductible under section 8-1 irrespective of whether

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the capital gain is included in assessable income. Accordingly, section 51AAA has no application to an Investor in the PEP.

Section 82KL of ITAA 1936

23. Section 82KL will not have any application as this section applies to deny a deduction for a tax benefit in certain situations arising out of a tax avoidance agreement. The PEP is not a tax avoidance arrangement.

Subdivision H of Division 3 of Part III of ITAA 1936

24. This Subdivision 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 an 'STS taxpayer', whether the Investor is an individual and whether the expenditure qualifies for transitional treatment. This Subdivision does not apply to 'excluded expenditure' which is defined in subsection 82KZL(1) to include amounts of less than \$1,000.

Subdivisions 328-F&G of ITAA 1997 – STS taxpayer

25. An Investor will be an STS taxpayer for an income year if the Investor is eligible to be an STS taxpayer for that year and the Investor notifies the Commissioner of the choice to become such a taxpayer for that year.

26. An Investor will be eligible to be an STS taxpayer for an income year if the Investor carries on a business and the STS average turnover of the business and related business for that year is less than \$1 million and the business and related businesses have depreciating assets with a total adjustable value below \$3 million at the end of that year.

The eligible service period for the purposes of Subdivision H of Division 3 of Part III of ITAA 1936

27. The PEP interest charge allowable under section 8-1 is in relation to a prepayment of loan interest for a period that is 12 months or less. Subparagraph 82KZL(2)(a) provides that a payment of interest that is made in return for the making available of a loan principal is to be taken, for the purposes of Subdivision H, to be expenditure incurred under an agreement in return for the doing of a thing under the agreement for the period to which the interest payment relates. The eligible service period in relation to a payment of loan

interest is determined by reference to the period to which the interest relates, which is one year, and not to the period of the loan, which is three years under the PEP.

Section 82KZM of ITAA 1936: prepaid expenditure incurred by STS taxpayers and individuals incurring non-business expenditure

28. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a taxpayer that is either:

- (i) an STS taxpayer for the year of income; or
- (ii) a taxpayer that is an individual and the expenditure is not incurred in carrying on a business;

and the expenditure is not excluded expenditure.

29. The section 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, in full, under section 8-1.

30. As the eligible service period in relation to the deductible PEP interest is 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 will have no application to Investors who are STS taxpayers 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 allowable PEP interest incurred.

Sections 82KZMA - 82KZMC of ITAA 1936: prepaid business expenditure incurred by non-STS taxpayers and prepaid non-business expenditure incurred by non-individual and non-STS taxpayers

31. Sections 82KZMA, 82KZMB and 82KZMC set the amount and timing of deductions for expenditure for an Investor (other than an STS taxpayer for the year of income) who:

- (i) carries on a business; or
- (ii) is a taxpayer that is not an individual and that does not carry on a business.

The expenditure must not be excluded expenditure and must be either incurred in carrying on a business, or incurred otherwise than in carrying on a business by a taxpayer that is not an individual. The

expenditure 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.

32. Sections 82KZMB, 82KZMC and 82KZMD operate to spread the deduction for the expenditure over the relevant eligible service period. Sections 82KZMA-82KZMC include transitional rules for phasing out the benefit of the immediate deductibility of such prepayments.

Sections 82KZME and 82KZMF of ITAA 1936: prepaid expenditure and ‘tax shelter’ type arrangements

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

34. For the purposes of section 82KZME, ‘agreements’ are broadly defined to include an entire arrangement of which a contract may form part. Under sub-section 82KZME(4), the relevant ‘agreement’ is all the contractual arrangements and activities associated with the participation in the PEP, including the financing, share purchase, share holding and disposal arrangements.

35. Exception 1, as contained in subsection 82KZME(5), applies to exclude the interest incurred on borrowings under the PEP from the operation of section 82KZMF, as:

- (i) the prepaid interest expenditure under the PEP is incurred in respect of money borrowed to acquire shares that are listed for quotation on the Australian Stock Exchange;
- (ii) the Investor can reasonably be expected to obtain dividends from the investment;
- (iii) the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- (iv) all aspects of the PEP are at arm’s length.

Accordingly, the tax shelter prepayment rules will not apply to Investors. Deductibility of expenditure must therefore be considered under the prepayment rules outlined in paragraphs 24 – 32 above.

Part IVA

36. Provided that the arrangement is entered into and carried out as disclosed (see paragraphs 10-13 above), it is accepted that the arrangement is a normal commercial transaction and Part IVA will not apply.

Detailed contents list

37. Below is a detailed contents list for this Ruling:

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Commissioner of Taxation

19 December 2001

Previous Ruling:

- tax avoidance

Not previously released in draft form

Legislative references:

Related Rulings/Determinations:

PR 2001/80; PR 2001/80E;
PR 1999/95; TR 92/1; TR 92/20;
TR 97/11; TR 97/16; TD 93/34;
TR 95/33; TR 98/22

- ITAA 1997 8-1
- ITAA 1997 Div 108 Part 3-1
- ITAA 1997 Div 110 Part 3-1
- ITAA 1997 Div 328 Part 3-45
- ITAA 1936 Part IVA
- ITAA 1936 51AAA
- ITAA 1936 82KL
- ITAA 1936 82KZL(2)(a)
- ITAA 1936 82KZM
- ITAA 1936 82KZMA
- ITAA 1936 82KZMB
- ITAA 1936 82KZMC
- ITAA 1936 82KZME

Subject references:

- financial products
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