



# ***PR 2001/80 - Income tax: deductibility of interest incurred on borrowings under the ANZ Protected Equity Portfolio Product***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *20 June 2001*



# Product Ruling

## Income tax: deductibility of interest incurred on borrowings under the ANZ Protected Equity Portfolio Product

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### *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**, **Ruling** and **Assumptions** parts of this document are a ‘public ruling’ in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 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**

Potential investors 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.

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. 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.

Potential investors 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 potential investors 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, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors 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**

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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**

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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 borrowing of moneys from Australia and New Zealand Banking Group Limited ('ANZ') under the ANZ Protected Equity Portfolio Product which is referred to in this Ruling as 'the PEP'.
2. This Ruling does not address the deductibility of interest incurred under the Loan Reset Option which is a feature of this product.

### **Tax law(s)**

3. The tax laws dealt with in this Ruling are:
  - section 8-1 of the *Income Tax Assessment Act 1997* ('the 1997 Act');
  - section 51AAA of the *Income Tax Assessment Act 1936* ('the 1936 Act');
  - Division 108 of Part 3-1 of the 1997 Act;
  - Division 110 of Part 3-1 of the 1997 Act;
  - section 82KL of the 1936 Act;
  - section 82KZM of the 1936 Act;
  - sections 82KZMA, 82KZMB, and 82KZMC of the 1936 Act;
  - sections 82KZME and 82KZMF of the 1936 Act; and
  - Part IVA of the 1936 Act.
4. Potential investors should note that amendments contained in the *New Business Tax System (Simplified Tax System) Bill 2000* will affect certain investors' eligibility to claim an immediate deduction for their deductible prepayments. (see paragraphs 38 to 42 below).

**Class of persons**

5. 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**

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

7. 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**

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9. This Ruling applies prospectively from 6 June 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).

10. 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

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11. This Product Ruling is withdrawn and ceases to have effect after 30 June 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

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

- Application for a Product Ruling dated 17 May 2001 received from Ernst & Young on behalf of ANZ;
- the PEP short form brochure received from Ernst & Young on 28 May 2001;
- the PEP Term Sheet received from Ernst & Young on 29 May 2001;
- the PEP Information Memorandum received from Ernst & Young on 28 May 2001;
- the Application Form received from Ernst & Young on 28 May 2001; and
- the PEP Lending Agreement received from Ernst & Young on 28 May 2001.

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

- (a) The PEP is a combined loan and option product for which Investors pay an annual Funding Rate. The Funding Rate comprises the interest rate and the put option premium rate. The Funding Costs is the amount calculated by applying the Funding Rate to the amount of the relevant loan.
- (b) Under the PEP, Investors borrow funds from ANZ under the PEP Lending Agreement. These funds are used to finance the purchase of a portfolio of securities

- in the Investor's own names ('PEP Securities'). Each Investor's portfolio of PEP Securities will consist of shares in at least four companies selected by the Investor from at least 20 Australian publicly listed companies specified by ANZ ('Approved Securities').
- (c) The loan under the PEP Lending Agreement is segmented into separate tranches corresponding to the funds applied to purchase each type of PEP Security.
  - (d) The minimum loan amount is \$50,000, with additional loan amounts available in \$50,000 increments. The minimum investment in any one company is \$10,000 and no more than 25% of the funds borrowed can be invested in any one company. Interest may be paid annually in advance or, alternatively, monthly in advance.
  - (e) The interest rate on the funds borrowed is a fixed interest rate as indicated on the PEP Term Sheet. Interest accrues daily, based on a 365 day year.
  - (f) The term of the loan is three years. Under clause 4.1 of the PEP Lending Agreement, ANZ may offer the Investor the opportunity to extend the term of the loan.
  - (g) Under the PEP, Investors also acquire a put option from ANZ. The rights under the put option are not transferable and not assignable without the written consent of ANZ. The put option may be exercised if, on the expiry date, the market value of a particular tranche of PEP Securities is less than the loan balance applicable to that tranche of PEP Securities. The put option, if exercised in respect of a tranche of PEP Securities, requires ANZ to purchase the tranche of PEP Securities for the amount ('Exercise Price') of the loan balance of that tranche. The Exercise Price will be applied by ANZ in satisfaction of the outstanding loan balance in respect of the particular tranche of PEP Securities. The put option premium is the excess of the interest rate charged over the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or 80% of the Funding Rate.
  - (h) Expenses in relation to the preparation, execution, amendment, enforcement and preservation of rights may be borne by the Investor. These may include, but are not limited to, share brokerage fees, stamp duty and Financial Institutions Duty on the purchase and sale of the Approved Securities.

- (i) Clause 4.4 of the PEP Lending Agreement provides that the Investor may undertake limited trading of the PEP Securities ('Passive Switch Option'). The Investor may request ANZ to sell all the PEP Securities held in a particular company if the market value of those shares has increased over the investment period. The proceeds from the sale will be applied on the Investor's behalf to acquire units in a widely held unit trust of the type described in sub-section 82KZME(5)(b)(iii) of the 1936 Act ('Approved Unit Trust'), until either the termination of the PEP or ANZ approves the following use:
- (i) to re-acquire the same number of PEP Securities which were previously sold; or
  - (ii) to repay the loan balance and pay any accrued interest, fees and other amounts owing under the PEP.

Alternatively, if an Investor requests the ANZ to pay out the net disposal proceeds which exceed the loan balance referable to that tranche of PEP Securities, this amount will be paid to the Investor. The balance will remain invested in the Approved Unit Trust.

- (j) Clause 4.5 of the PEP Lending Agreement provides that in certain circumstances, if the Market Value of the Approved Securities has increased over the investment period, then the Investor may request ANZ to make a further loan to the Investor equal to the increase in the value of the PEP Securities ('Loan Re-Set Option'). This feature is not ruled upon in this ruling – see paragraph 2 above.
- (k) On expiry of the PEP, Investors may discharge their repayment obligations in several ways:
- (i) repay the entire loan using their own funds and retain title to the PEP Securities;
  - (ii) where the market value of a particular tranche of PEP Securities is greater than the loan balance relating to that tranche at the expiry date, instruct ANZ to dispose of the PEP Securities. In such a case ANZ will apply the net proceeds of the sale in repayment of the tranche of the loan applicable to those securities. ANZ will pay the Investor an amount by which the net proceeds of the disposal exceed the loan amount; or

- (iii) where the market value of a particular tranche of PEP Securities is less than the loan balance relating to that tranche at the expiry date, exercise the put option in respect of the particular tranche of shares, requiring ANZ to acquire the PEP Securities in satisfaction of the loan balance in respect of that tranche of shares.
- (l) As all PEP Securities that the Investor selects are held in the Investor's name, any dividends paid in respect of the PEP Securities are paid to the Investor.
- (m) The Investor receives the benefit of any rebates or credits attaching to any dividends received, subject to the 'at risk' holding period rules applying generally to shares.
- (n) The Investor receives the benefit of any Bonus or Rights Issues, subject to the provision that any additional shares acquired will form part of loan security for the loan.
- (o) If a PEP Security is subject to a takeover offer that becomes a compulsory acquisition, the Investor may be required to repay that portion of the loan balance. Any costs associated with early termination will be borne by the Investor.
- (p) If the Approved Securities are subject to a return of capital, ANZ may purchase additional shares at the Investor's expense in order to restore the value of ANZ's loan security.

### **The Participants**

- 14. Under the PEP, ANZ is the provider of the loan(s) and the put option.
- 15. Investors in the PEP may include individuals, companies and trusts.

### **Ruling**

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- 16. Subject to the assumptions listed below:
  - (i) Part of the Funding Costs charged under the PEP is a capital protection fee and is not deductible under section 8-1 of the 1997 Act.

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- (ii) The PEP interest charge allowable under section 8-1 of the 1997 Act is the amount that does not exceed the benchmark interest rate calculated as the lower of the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans or 80% of the Funding Costs charged by ANZ. As the interest rate charged on the PEP is a fixed rate the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans Fixed is used.
- (iii) The put option premium, as calculated by reference to the Put Option Premium Rate set out in the Term Sheet, payable under the PEP is not an allowable deduction pursuant to section 8-1 of the 1997 Act. The premium is capital in nature, being paid to acquire an asset, namely, the put option.
- (iv) The amount of the interest charged that is not deductible under the formula described above in paragraph 16(ii) represents the payment for a put option by instalments and becomes part of the cost base of this put option.
- (v) Section 51AAA of the 1936 Act will not apply to deny the PEP interest charge allowable under section 8-1 of the 1997 Act.
- (vi) Section 82KL, a specific anti-avoidance provision of the 1936 Act, will not apply to deny deductibility of the PEP interest charge allowable under section 8-1 of the 1997 Act.
- (vii) Section 82KZM of the 1936 Act will not apply to deny immediate deductibility for the PEP interest charge incurred by the Investor in respect of borrowings used to fund the purchase of the PEP securities, where the Investor is either a small business taxpayer or does not incur the interest expenditure in carrying on a business.
- (viii) Sections 82KZMA, 82KZMB and 82KZMC of the 1936 Act will apply to determine the amount and timing of deductions for the PEP interest charge incurred in respect of borrowings used to fund the purchase of the PEP Securities where the expenditure is incurred by an Investor (other than a small business taxpayer), in carrying on a business.
- (ix) Section 82KZMF of Subdivision H of Division 3 of Part III of the 1936 Act will not apply to set the amount and timing of deductions for the PEP interest charge.

- (x) The anti-avoidance provisions contained in Part IVA will not be applied to deny deductibility of the interest incurred by the Investor in respect of borrowings used to fund the purchase of PEP Securities.

**IMPORTANT:** Paragraphs 16(vii) to 16(ix) above describe the deductions that are allowable to Investors under current law, but Investors are advised to carefully examine the information contained in paragraphs 38 to 42 relating to proposed changes to the prepayment rules.

## **Assumptions**

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

- (i) All of the Investors are Australian residents;
- (ii) The Investors are not traders in investments and are not treated for taxation purposes as either trading in PEP Securities or carrying on a business of investing in PEP Securities. Further, the Investors do not otherwise hold the PEP Securities as revenue assets;
- (iii) In respect of any interest charges to be paid in advance under the PEP Lending Agreement, these may be prepaid, but only in relation to a loan interest payment period of 12 months or less;
- (iv) The Investors will derive assessable income from the investment in the PEP Securities. That assessable income will not include income other than trust income (where the Investor has exercised the Passive Switch Option), dividends and capital gains receipts;
- (v) The dominant purpose of an Investor in entering the arrangement is to derive assessable income from their investment in the PEP Securities;
- (vi) The arrangement will be executed in the manner described in the 'Arrangement' section of this Ruling;
- (vii) All dealings by the Investors and ANZ will be at arm's length; and
- (viii) The Investors will not terminate the arrangement early.

## **Explanations**

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### **Section 8-1 of the 1997 Act**

18. 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).

19. The ATO view expressed in media release Nat 99/26 is that part of the Funding Costs 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.

20. The ATO view is that part of the Funding Costs under the PEP, described as the put option premium, is a capital protection fee and is not deductible under section 8-1.

21. 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 or 80% of the Funding Costs charged by ANZ. As the interest rate charged on the PEP is a fixed rate the Reserve Bank Bulletin Indicator Lending Rates for Personal Unsecured Loans Fixed is used.

22. The ATO view is that the put option premium is not deductible because it is incurred for a purpose other than to service or maintain the borrowed funds. The premium is capital in nature, being paid to acquire an asset, namely, the put option.

23. 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 ANZ will acquire the shares in full satisfaction of the loan amount if the shares have fallen in value below the amount borrowed. Accordingly, the put option premium is a capital protection fee.

24. 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 the 1936 Act**

25. Under the PEP it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income as well as by way of capital gain.

Accordingly, the interest would have been deductible under section 8-1 irrespective of whether the capital gain is included in assessable income, or, more precisely, a deduction would have been allowable irrespective of whether the capital gain has been included in assessable income. Accordingly, section 51AAA has no application to an Investor in the PEP.

### **Section 82KL of the 1936 Act**

26. The operation of section 82KL 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. It will not apply to deny the deduction otherwise allowable under section 8-1.

### **Subdivision H of Division 3 of Part III of the 1936 Act**

27. This Subdivision deals with the timing of deductions for certain prepaid expenditure. Separate rules apply depending on whether the expenditure is incurred in carrying on a business, whether the Investor is a 'small business taxpayer' and whether the expenditure qualifies for transitional treatment.

### ***Subdivision 960-Q of the 1997 Act - Small business taxpayers***

28. A 'small business taxpayer' is defined in sections 960-335 and 960-350. In broad terms, a 'small business taxpayer' is a taxpayer that has an average turnover of less than \$1,000,000 from business activities.

29. Whether an Investor is a 'small business taxpayer' depends upon the individual circumstances of each Investor and is beyond the scope of this Ruling. It is the individual responsibility of each Investor to determine whether or not they are within the definition of a 'small business taxpayer'.

### ***The eligible service period for the purposes of Subdivision H of Division 3 of Part III of the 1936 Act***

30. The PEP interest charge allowable under section 8-1 is in relation to a prepayment of loan interest for a period less than 13 months. Paragraph 82KZL(2)(a) states 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 the 1936 Act: prepaid expenditure incurred by small business taxpayers and non-business expenditure***

31. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a small business taxpayer or for prepaid expenditure not incurred in carrying on a business that would otherwise be immediately deductible, in full, under section 8-1. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly to be done within 13 months after the day on which the expenditure is incurred.

32. As the eligible service period in relation to the deductible PEP interest is less than 13 months, section 82KZM will have no application to small business taxpayers nor to Investors who are not carrying on a business.

***Sections 82KZMA - 82KZMC of the 1936 Act: prepaid business expenditure incurred by non-small business taxpayers***

33. For an Investor (other than a small business taxpayer) who incurs expenditure in carrying on a business for the doing of a thing that is not to be wholly done within the expenditure year, the deduction for the expenditure is spread 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 the 1936 Act prepaid expenditure and 'tax shelter' type arrangements***

34. 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 to be wholly done within 13 months after the day on which the expenditure is incurred, but not wholly within the expenditure year.

35. 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.

36. 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, or units in a trust (as described in subparagraph 82KZME(5)(b)(iii)) where the Passive Switch Option is exercised;
- (ii) the Investor can reasonably be expected to obtain dividends or trust income 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,

#### **Part IVA**

37. Provided that the arrangement is entered into and carried out as disclosed (see paragraphs 12-15 above), it is accepted that the arrangement is a normal commercial transaction and Part IVA will not apply.

#### **Proposed changes to prepayment rules**

38. The amendments contained in the *New Business Tax System (Simplified Tax System) Bill 2000* introduce a new 12-month prepayment rule. Under this rule, an advance payment made by a STS taxpayer (that is, a small business taxpayer that has entered the Simplified Tax System) or an individual incurring deductible non-business expenditure will be immediately deductible where:

- it is incurred in respect of a period of service not exceeding 12 months; and
- the period of service ends no later than the last day of the income year following the date on which the payment is made.

39. Small business taxpayers not entering the Simplified Tax System and non-individual taxpayers who are incurring deductible non-business expenditure will have to apportion their deductions for incurred deductible prepayments over the service period.

40. These changes will apply to assessments for the first year of income starting after 30 June 2001 and later years of income.
41. The information given in paragraphs 38 to 40 above is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant laws are enacted.
42. If the changes become law the operation of that law will take precedence over the application of this Ruling and, to that extent, this Ruling will become superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding information shown in this Ruling by issuing a new Product Ruling that describes the operation of those laws.

## **Detailed contents list**

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43. Below is a detailed contents list for this Product Ruling:

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**Commissioner of Taxation**

6 June 2001

*Legislative references:*

<i>Previous draft:</i>	- ITAA 1997 8-1
Not previously issued in draft form	- ITAA 1997 Div 108 Part 3-1
	- ITAA 1997 Div 110 Part 3-1
<i>Related Rulings/Determinations:</i>	- ITAA 1997 Subdiv 960-Q
PR 1999/95; TR 92/1; TR 92/20;	- ITAA 1997 960-335
TR 97/11; TR 97/16; TD 93/34;	- ITAA 1997 960-350
TR 95/33; TR 98/22	- ITAA 1936 51AAA
	- ITAA 1936 82KL
<i>Subject references:</i>	- ITAA 1936 82KZL(2)(a)
- financial products	- ITAA 1936 82KZM
- interest expenses	- ITAA 1936 82KZMA
- prepaid expenses	- ITAA 1936 82KZMB
- product rulings	- ITAA 1936 82KZMC
- public rulings	- ITAA 1936 82KZME
- small business taxpayer	- ITAA 1936 82KZME(4)
- taxation administration	- ITAA 1936 82KZME(5)
- tax avoidance	- ITAA 1936 82KZME(5)(b)(iii)
	- ITAA 1936 82KZMF

## ATO references:

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