


# ***PR 2017/8 - Income tax: tax consequences of investing in the Macquarie Torque Swap***

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## Product Ruling

### Income tax: tax consequences of investing in the Macquarie Torque Swap

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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.

### **No guarantee of commercial success**

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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**

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This Product Ruling has been given on the basis that the entity(s) who 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

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1. This Product Ruling sets out the Commissioner's opinion on the way in which the relevant provisions identified in the Ruling section (below) apply to the defined class of entities who take part in the scheme to which this Ruling relates. All legislative references in this 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 the Swap, being the Macquarie Torque Swap offered by Macquarie Bank Limited (MBL) as part of the Macquarie Torque Facility (Facility).

3. This Product Ruling does not address:

- the tax consequences of utilising the optional Loan facility
- the tax consequences of optional Vanilla Put Options
- the tax consequences of optional Knock-out Put Options
- the tax consequences of the disposal of the Reference Assets
- the tax consequences of a transfer of the Reference Assets to or from the Nominee in accordance with the nominee arrangements
- the assessability of any dividends or other distributions received, or entitled to be received, by an Investor in respect of their Reference Assets
- an Investor's entitlement to franking credits
- the tax consequences of an Early Termination Event occurring
- the tax consequences of a Potential Adjustment Event occurring
- the tax consequences of an Exceptional Circumstance occurring
- the tax consequences of an assignment or transfer of an Investor's interest under the Facility
- the tax consequences of any brokerage fees and/or other associated transactional costs incurred by an Investor under the Facility, and
- whether the Swap constitutes a financial arrangement for the purposes of Division 230 (Taxation of financial arrangements).

**Class of entities**

4. 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.

5. The class of entities that can rely on the Ruling section of this Product Ruling consists of those entities that:

- (a) are Australian residents for taxation purposes
- (b) enter into the scheme described in paragraphs 15 to 19 of this Product Ruling on or after the date this Product Ruling is published, being 5 July 2017, and on or before 30 June 2020
- (c) at the time of entering into the scheme, have a purpose of staying in the scheme until it is completed (that is being a party to the relevant agreements until their term expires), and
- (d) at the time of entering into the scheme, have a realistic expectation of deriving a net gain from their involvement in the Swap.

These entities are referred to as Investors.

6. The class of entities that can rely on the Ruling section of this Product Ruling does **not** include entities that:

- (a) are not Australian residents for taxation purposes
- (b) intend to terminate their involvement in the scheme prior to its completion, or who otherwise do not intend to derive a net gain from it
- (c) are accepted to participate into the scheme before the date of this Ruling or after 30 June 2020
- (d) participate in the scheme through offers made other than through the Macquarie Torque Facility Product Disclosure Statement (PDS), or who 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
- (e) trade in financial investments or securities and are treated for taxation purposes as trading in the Reference Assets, carrying on a business of investing in the Reference Assets, or holding interests in the Reference Assets as trading stock or as revenue assets, or
- (f) 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.

## Qualifications

7. 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 15 to 19 of this Ruling.

8. 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

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9. This Product Ruling applies prospectively from 5 July 2017, the date it is published. It therefore applies only to the specified class of entities that enter into the scheme from 5 July 2017 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.

10. However, the 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

11. 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 this Product Ruling and, to that extent, this Product Ruling will have no effect.

12. Entities who 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**

13. 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**

14. Subject to paragraph 3 and the assumptions in paragraph 19 of this Ruling:

- (a) The net gain or loss made on maturity of the Swap constitutes respectively either assessable income under section 6-5 or an allowable deduction under section 8-1 arising from the Swap to the Investor.
- (b) The gross receipt(s) and payment under the Swap are not income according to ordinary concepts but receipt(s) and outgoing of capital. It is the difference between the gross receipt(s) and payment, that is, the net gain or loss, that is on revenue account and hence either assessable income or an allowable deduction for an Investor.
- (c) The assessment of the income or deduction made under the Swap by an Investor is determined when the net gain or loss emerges on maturity of the Swap to reflect the Investor's true income from the Swap.
- (d) Subdivision H of Division 3 of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) does not apply to an Investor in the Swap.
- (e) The Swap is not a qualifying security held by an Investor as defined in subsection 159GP(1) of the ITAA 1936. Therefore, Division 16E of Part III of the ITAA 1936 does not apply to the Swap.
- (f) Provided the scheme ruled on is entered into and carried out as described in this Ruling, the anti-avoidance provisions in Part IVA of the ITAA 1936 will not apply to an Investor in respect of the Swap.

**Scheme**

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

- application for a Product Ruling as constituted by documents and information received on

12 September 2016, 27 September 2016,  
1 November 2016, 14 February 2017, 13 June 2017  
and 27 June 2017

- PDS dated 5 July 2017, and
- Macquarie Torque Facility Terms and Conditions dated 5 July 2017.

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

16. For the purposes of describing the scheme to which this 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. Unless otherwise defined, capitalised terms in this Ruling take their meaning as per the Glossary in the Terms and Conditions referred to in paragraph 15 of this Ruling.

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

## Overview

18. Following is a summary of the scheme:

- (a) Under the Facility the Investor (being an individual, corporate entity or trust (other than a superannuation fund)) may:
- enter into one or more Swaps
  - protect the value of their investment in particular Securities by acquiring Vanilla Put Options and/or Knock-out Put Options
  - procure one or more Loans that are linked to one or more Vanilla Put Options acquired, and/or
  - buy Securities funded with the Investor's own cash, or with the proceeds of a Loan.

### *Swap*

- (b) Following acceptance of the Investor's Application to enter into the Facility, the Investor may make one or more Transaction Requests to acquire one or more Swaps under the Facility. A Transaction Request for a Swap must (unless MBL otherwise agrees and subject to any other information reasonably requested by MBL) specify:

- the type and number (or face value) of Reference Assets that the Swap will relate to
  - the proposed Swap Strike Price or Swap Strike Price Percentage (if any)
  - the proposed Fixed Coupon(s) and any related Fixed Coupon Payment Date(s)
  - the desired Start Date, and
  - the desired Expiry Date.
- (c) The Swap consists of a Swap Agreement between the Investor and MBL as counterparties. Under the Swap the Investor receives one or more Fixed Coupons on the relevant Fixed Coupon Payment Date(s) from MBL. The Fixed Coupons are calculated by MBL upon its acceptance of, and with reference to, the terms set out in the Investor's Transaction Request, and constitute the 'fixed leg' of the Swap.
- (d) The Investor agrees to pay MBL the Swap Settlement Amount on the Swap Settlement Date (following the Swap's Expiry Date). The Swap Settlement Amount is calculated based on the performance of the underlying Reference Assets over the term of the Swap and constitutes the 'floating leg' of the Swap.
- (e) The Swap Settlement Amount payable by the Investor will be zero if the Final Price of the Reference Assets at the Expiry Date is equal to or less than the Swap Strike Price of the Reference Assets.
- (f) The Reference Assets consist of a parcel of shares or units listed or quoted on the Australian Securities Exchange, or any other financial product, unit, Stapled Security or security acceptable to MBL. The Investor must either already own the Reference Assets prior to their entry into the Swap, or purchase the Reference Assets on entering into the Swap.
- (g) At the Investor's request, the term of each Swap will generally be between 6 months and 6 years and relate to Reference Assets having an initial market value of at least \$500,000 (or lesser amount as determined by MBL).
- (h) No fee is payable by the Investor on issue of the Swap.
- (i) The Investor may terminate their Swap at any time with MBL's consent, but will be required to pay any applicable Swap Early Lapse Amount. This Ruling does not consider the tax consequences of an early termination.



*Loan and security arrangements*

- (j) The proceeds of a Loan procured by the Investor from MBL may be used to finance all or part of the purchase price of the Reference Assets (where the Reference Assets are also the subject of Vanilla Put Options acquired under the Facility), or for other business or investment purposes (other than investment in residential real estate).
- (k) To the extent that the Reference Assets are not funded via a Loan, the Investor must either pay the remaining purchase price for the Reference Assets, or have existing holdings of the Reference Assets which will become subject to the Security Arrangements (referred to in paragraph 18(l) below). In addition, MBL may require the Investor to contribute additional assets which will become subject to the Security Arrangements.
- (l) For the purposes of securing the rights of MBL under the Facility (including MBL's right to receive the Swap Settlement Amount and any Swap Early Lapse Amount under the Swap Agreement), the Investor, as legal and beneficial owner of the Secured Property (including the Reference Assets), grants a Mortgage to MBL over all of the Investor's present and future right, title and interest, in and to, the Secured Property. As further security, the Investor may be required from time to time (at MBL's direction) to transfer to the Nominee some or all of the Secured Property which is subject to the Mortgage.
- (m) The Investor will at all times hold the beneficial interest in the Secured Property and will be entitled to any dividends and/or distributions paid in respect of the Secured Property.
- (n) On the Repayment Date, the Investor must repay any outstanding portion of the Loan to MBL.

*Options*

- (o) The Options available under the Facility constitute an irrevocable offer by MBL to the Investor, on effective exercise of the Options during the Exercise Period, to either buy the Reference Assets for the Option's Protection Price (on receipt of a valid Sell Instruction and subject to MBL's discretion regarding Sell Instructions), or to pay the Investor any Option Cash Settlement Amount on the Cash Settlement Payment Date (on receipt of a valid Cash Settlement Request). The Investor can elect to pay for the cost of each Option as a Premium on the Premium Payment Date

or as a component of the Interest Rate payable on the Loan (if any).

**Assumptions**

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

- (a) the Investor is an Australian resident for taxation purposes
- (b) the Investors are not traders in financial investments or securities and are not treated for taxation purposes as trading in the Reference Assets, carrying on a business of investing in the Reference Assets, or holding interests in the Reference Assets as trading stock or as revenue assets
- (c) the dominant purpose of an Investor in entering the scheme is to derive a net gain
- (d) the Investors have not made an election under subsection 230-455(7) to have Division 230 apply
- (e) 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 15 of this Ruling, and
- (f) all dealings between the Investors and MBL under the scheme will be at arm's length.

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**Commissioner of Taxation**

5 July 2017

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## 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 6-5 and section 8-1

20. The Swap is a bilateral agreement obligating MBL to exchange one or more fixed payments (the Fixed Coupons) at specified intervals in return for a floating payment (the Swap Settlement Amount) ascertained from applying financial prices (for example market indices). The specified underlying amount is a notional principal amount which is not exchanged.

21. The Swap is a financial derivative the value of which is derived from or calculated by reference to the performance of underlying Reference Assets.

22. An Investor's purpose for entering into the Swap can be considered to be to make a profit through speculation (attempting to make a profit by correctly forecasting movements in the market).

23. Under section 6-5 an amount is assessable income if it is income according to ordinary concepts. The case law establishes that a net amount or net profit may constitute income according to ordinary concepts (refer to *Commercial and General Acceptance Ltd v. FC of T* (1977) 137 CLR 373; 77 ATC 4375; (1977) 7 ATR 716 per Mason J at CLR 382-383; ATC 4380; ATR 721-722, with whom Barwick CJ and Gibbs J agreed). However, a net profit will only be considered income when the gross receipt from which it is calculated itself lacks the character of income.

24. Income is a gain from the carrying on of organised activity directed to the making of gains. In particular, as an Investor's intention or purpose in entering into the Swap is to make a profit or gain, the profit or gain will be income, notwithstanding that the transaction was extraordinary, judged by reference to the Investor's ordinary business (*FC of T v. Myer Emporium Ltd* (1987) 163 CLR 199; 87 ATC 4363; (1987) 18 ATR 693). The gain must be of revenue rather than capital nature in order to constitute income according to ordinary concepts.

25. Applying the same rationale, where an Investor's intention or purpose in entering into the Swap is to make a profit or gain, any net loss generated is incurred in gaining or producing assessable income and shall be deductible under section 8-1.

**The gross receipts and payment under the Swap are not on revenue account**

26. The Swap is essentially speculative and undertaken with the object of making a profit with regard to the judicial commentary and accounting and business practice (see *Commissioner of Taxes (S.A.) v. Executor Trustee and Agency Co. of South Australia Ltd* (1938) 63 CLR 108 (*Carden's case*) per Dixon J at 152-4).

27. The income status of gross receipts received under the Swap is determined from a commercial perspective. An analogy is drawn between swaps and futures contracts which also involve an element of speculation. The gain or loss from futures contracts is generally assessable or deductible, whether those futures contracts are entered into as part of a futures trader's operations or for hedging or speculative purposes.

28. Thus, the judicial analysis of swaps as commercial contracts of speculation entered into with a view to profit would indicate that it is the difference between the receipts and payments under the Swap that is the income (or loss) to the Investor. The gross amounts are reciprocally payable (although not necessarily in the same period) and the difference between those amounts is a gain or a loss, according to the circumstances as dictated by movements in the performance of the underlying Reference Assets. On such an analysis, it is difficult to regard the Swap payment and receipt(s) as expense and income respectively. Rather, they are in the nature of payments and receipts which have the flavour of flows of circulating capital. Only the net gain realised by an Investor on the Swap can properly be regarded as income. Similarly, where the receipt is less than the payment a net loss results.

**The timing of income from the Swap**

29. Pursuant to subsection 6-5(2) ordinary income is included in the assessable income of an Investor when it is derived by that Investor. The word 'derived' is not defined under the *Income Tax Assessment Act* but is equivalent to 'arising or accruing' (*Harding v. FC of T* (1917) 23 CLR 119 per Isaacs J at 133). Income is taken to be derived when it has 'come home' to the Investor, that is to say it has been earned and, depending on the nature of the source of the income, there is sufficient certainty as to its being realised (*Carden's case* per Dixon J at 155-159). Such certainty is determined by reference to not only legal rights and obligations but also business and commercial realities (*Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; 14 ATD 98 at CLR 318-319; ATD 99-100).

30. The time at which an amount represents 'income derived' by an Investor depends on the nature of the income and the circumstances in which it is derived. Further, the accounting method to be used in determining when income is derived depends on its 'actual appropriateness' and in particular on 'whether in the circumstances of the case it is calculated to give a substantially correct reflex of the taxpayer's true income' (*Carden's case* per Dixon J at 155).

31. In the case of an Investor in the Swap, the net gain or loss made will be assessed in the period in which it arises.

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

32. Subdivision H of Division 3 of Part III of the ITAA 1936 (Subdivision H) changes the timing of deductions under section 8-1 of the ITAA 1997 for expenditure meeting the requirements of the Subdivision. Broadly, the effect of Subdivision H is to deny immediate deductions for expenditure subject to the Subdivision and instead to spread the deductions over the period to which the expenditure relates (to a maximum of 10 years).

33. The mechanism by which Subdivision H spreads the deduction is through the application of certain operative provisions, each of which applies in separate circumstances depending on the time at which the expenditure was incurred and the type of expenditure incurred.

34. However, Subdivision H only applies to spread the deduction for an amount of expenditure if the expenditure is, otherwise deductible under section 8-1 of the ITAA 1997 or certain other deduction sections; not 'excluded expenditure' as defined in subsection 82KZL(1) of the ITAA 1936; and incurred for things not to be done wholly within specified periods depending on which operative provision the expenditure falls under.

35. Subdivision H only applies to 'expenditure' that is otherwise deductible. As the gross payment under the Swap is not otherwise deductible to an Investor under section 8-1 of the ITAA 1997, only the net loss is susceptible to the operation of Subdivision H. A loss may not be 'expenditure' as expenditure has to be made, and connotes something which is passing out from the taxpayer (*Gross v. FC of T* (1999) 99 ATC 4196; (1999) 42 ATR 205 at ATC 4207; ATR 217). However, even if expenditure were to be acknowledged to include a loss then, as the loss relates to the income year in which it is incurred, there is nothing for Subdivision H to operate with respect to, and thus Subdivision H would not displace when such losses are regarded as deductible. Thus, Subdivision H does not apply to losses arising to an Investor under the Swap.

**Division 16E of Part III of the ITAA 1936**

36. Division 16E of Part III of the ITAA 1936 (Division 16E) was enacted to prevent tax deferral opportunities which were available from certain discounted and deferred interest securities. Under Division 16E, the income and deductions from these securities are spread over the term of the security on a basis which reflects the economic gains and losses which have accrued at any point in time.

37. For Division 16E to apply, the transaction must satisfy the definition of 'qualifying security' in subsection 159GP(1) of the ITAA 1936. For the purposes of determining whether the Swap is a qualifying security, the Swap must be a 'security', also defined in subsection 159GP(1) of the ITAA 1936 to mean:

- (a) stock, a bond, debenture, certificate of entitlement, bill of exchange, promissory note or other security;
- (b) a deposit with a bank, building society or other financial institution;
- (c) a secured or unsecured loan; or
- (d) any other contract, whether or not in writing, under which a person is liable to pay an amount or amounts, whether or not the liability is secured.

38. The Swap is not considered to have sufficient debt like obligations to be a contract to which paragraph (d) of the definition of security in subsection 159GP(1) of the ITAA 1936 applies, nor does it fall within paragraphs (a), (b) or (c) of that definition. Therefore, the Swap does not meet the definition of security under subsection 159GP(1) of the ITAA 1936 and, as such, is not a qualifying security for the purposes of Division 16E.

39. Accordingly, Division 16E does not apply to the net income or loss amount arising to an Investor under the Swap.

**Part IVA – anti-avoidance**

40. 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 (see paragraphs 15 to 19 of this Ruling), it is accepted that the scheme is an ordinary commercial transaction and Part IVA of the ITAA 1936 will not apply.

## **Appendix 2 – Detailed contents list**

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41. The following is a detailed contents list for this Ruling:

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## References

### *Previous draft:*

Not previously issued as a draft

### *Legislative references:*

- ITAA 1936
  - ITAA 1936 Pt III Div 3 Subdiv H
  - ITAA 1936 82KZL(1)
  - ITAA 1936 Pt III Div 16E
  - ITAA 1936 159GP(1)
  - ITAA 1936 Pt IVA
  - ITAA 1997
  - ITAA 1997 6-5
  - ITAA 1997 6-5(2)
  - ITAA 1997 8-1
  - ITAA 1997 Div 230
  - ITAA 1997 230-455(7)
  - TAA 1953
- Case references:*
- Arthur Murray (NSW) Pty Ltd v. Federal Commissioner of Taxation - (1965) 114 CLR 314; (1965) 39 ALJR 262; (1965) 14 ATD 98; [1965] HCA 58
  - Commercial and General Acceptance Ltd v. Federal Commissioner of Taxation - (1977) 137 CLR 373; (1977) 51 ALJR 842; (1977) 16 ALR 267; (1977) 7 ATR 716; 77 ATC 4375; [1977] HCA 47
  - Commissioner of Taxes (SA) v. Executor Trustee and Agency Co of South Australia Ltd - (1938) 63 CLR 108; (1938) 12 ALJ 407; (1938) 5 ATD 98; [1939] ALR 81; [1938] HCA 69
  - Federal Commissioner of Taxation v. Myer Emporium Ltd - (1987) 163 CLR 199; (1987) 61 ALJR 270; (1987) 71 ALR 28; (1987) 18 ATR 693; 87 ATC 4363; [1987] HCA 18
  - Gross v. Commissioner of Taxation - (1999) 85 FCR 270; (1999) 42 ATR 205; 99 ATC 4196; [1999] FCA 45
  - Harding v. Federal Commissioner of Taxation - (1917) 23 CLR 119; (1917) R and McG 5; (1917) 23 ALR 137; [1917] HCA 13

### ATO references

NO: 1-9UJ7C98

ISSN: 2205-6114

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

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