IT 2513 - Income tax : margin lending

TAXATION RULING NO. IT 2513

INCOME TAX : MARGIN LENDING

F.O.I. EMBARGO: May be released

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REFERENCE NO:	SUBJECT REFS:	LEGISLAT. REFS:
I 1010972	LOAN ARRANGEMENT	19
	INTEREST	25
	MARGIN LENDING	46
	AVOIDANCE OF TAX	46D
		177C
		177D
		Part IVA

PREAMBLE This Ruling considers the income tax implications of payments received or receivable by a lender under a tax avoidance financing arrangement utilising the borrower's rebatable dividends to discharge the liability for what amounts in substance to interest payments. This financing arrangement is commonly referred to as a "margin lending" arrangement.

2. The basic arrangement concerns loans secured against company shares. The borrower assigns or otherwise directs the stream of dividends from the shares to the lender purportedly in lieu of having to make interest payments. The lender claims that the dividends are effectively tax free, on the basis of the lender's entitlement to the section 46 rebate on inter-corporate dividends. On the basis of the purported tax benefits of the arrangement, the lender accepts a lower pre-tax rate of return than it would require if the return was in the more usual form of interest.

3. The borrower in the arrangement uses the funds to acquire shares or, having already acquired shares from other resources, refinances the acquisition to maximise the tax benefits of rebatable dividends. The arrangements may also be utilised to raise funds for any other purpose. The arrangement would be attractive to borrowers who are not currently able to use the rebates because of carry forward losses, or who are otherwise non-taxable, and to non-resident taxpayers who are unable to obtain the benefit of income tax rebates for dividends.

4. There are variations in the arrangement but they have basic common features. The factual basis of this Ruling relates to an arrangement recently examined by this office which had all the common features.

5. The margin lending arrangement was structured in the following manner :

- the lender agreed to lend the borrower an amount of money upon certain terms and conditions, one of which was that the borrower was to repay that amount on a certain date or on the happening of any one of a number of specified events;

- the borrower purportedly agreed to give, by way of security to the lender, a legal mortgage over a large parcel of shares in a public company that the borrower had purchased. As part of the agreement the shares were transferred from the borrower to the lender and the company in which the shares were held registered the transfer;

- during the finance period, the dividends on the shares were directed to the lender on the basis that it was the "shareholder". The lender included the dividends in its assessable income and claimed a section 46 rebate, effectively treating the dividends as tax free;

- under a separate agreement ("the Investment Agreement"), the lender was guaranteed a specified rate of return on the investment (the "Investment Return") calculated by reference to the amount of the funds it advanced and to the period during which they were outstanding;

- the Investment Return was to be satisfied by the dividends on the relevant shares. To the extent that the amount of dividends was insufficient to meet the Investment Return, the short-fall was required to be topped up by direct payment from the borrower described as a "management fee". The total amount of cash required to satisfy the required rate of return was calculated on the assumption that it was tax free in the lender's hands. In other words, the amount of cash required would have been greater under an ordinary loan arrangement under which interest derived by the lender would have been assessable unreduced by any rebate;

- in the event that the dividends exceeded the Investment Return, the borrower was to be refunded the excess;

- during the finance period, the borrower was able to exercise the voting rights in respect of the shares either by way of appointment as proxy or by requiring the lender to exercise those rights in accordance with instructions given by the borrower;

- any bonus issues, options or other rights in respect of the relevant shares were to be accepted by the lender only after obtaining the approval of the borrower and then only as a trustee for the borrower;

- provided the borrower did not default under the arrangements, the lender could not dispose of, or otherwise deal with, the shares;

- the arrangements provided for the shares to be transferred back to the borrower at the end of the finance period. The finance period could be cut short if the dividends were not treated as rebatable for tax purposes; and

- the borrower agreed to indemnify the lender against any loss arising from denial of the dividend rebate.

RULING

6. Arrangements of the type described above are, as between the borrower and lender, properly to be characterised as one of loan, with the borrower paying amounts of principal and interest albeit that the payment of interest is, at least in part, satisfied by the borrower diverting to the lender dividends to which it is entitled. The amount representing interest is fully assessable to the lender.

7. The "Investment Return" under the arrangement is interest by definition and by ordinary income tax concepts. In F.C. of T v. The Myer Emporium Ltd (1987) 163 CLR 199, the Full High Court restated some basic principles relating to "interest" which are relevant : "interest is regarded as flowing from the principal sum (Federal Wharf Co. Ltd v. D.F.C. of T. (1930) 44 CLR 24 at p.28) and to be compensation to the lender for being kept out of the use and enjoyment of the principal sum : Riches v. Westminster Bank Limited [1947] A.C. 390 at p.400". The Investment Return under the arrangement satisfies the definition of "interest" as enunciated by the High Court.

8. Reference may also be made to Jowitt's Dictionary of English Law which provides a functional description of "interest" :

> "Interest is calculated at a rate proportionate to the amount of principal and to the time during which the non-payment continues; this rate is generally expressed as so much for every hundred pounds ('per centum') during a year ('per annum')".

The Investment Return was calculated in this manner.

9. In the case of a person whose business includes that of money lending, such as banks, insurance companies and finance companies, interest income is derived on an accruals basis (see Commr. of I.R. (N.Z) v. The National Bank of New Zealand Ltd 77 ATC 6001; 7 ATR 698, discussed by the Full Federal Court in F.C. of T. v. National Commercial Bank of Aust. Ltd 83 ATC 4715; 15 ATR 21. See also FCT v. Australian Guarantee Corporation Limited 84 ATC 4642; 15 ATR 982.) In terms of the agreement to receive the Investment Return, interest would accrue to the lender as and when it becomes due. The total interest accruals of such lenders become assessable as they accrue and have the character of income by ordinary concepts assessable under subsection 25(1). The actual receipt of the dividends merely extinguishes, in part, the interest so accrued or due on the outstanding loan. Consistent with this, the lender is to be

assessed on the basis of the interest (or, as referred to, the Investment Return) provided for in the Investment Agreement rather than on the collateral arrangements for the diversion of dividends to the lender. It is the primary view of this office that, on the basis of this assessment, the lender would not be entitled a section 46 rebate, being assessed to income tax in respect of interest rather than dividends.

10. Alternatively, it can be said that the interest obligation of the borrower is satisfied, at least in part, by what is left in the hands of the lender after the dividends are received and any allowable rebate on those dividends has been taken into account.

11. On this alternative basis, the view is taken that the proper construction of the Mortgage Agreement and the Investment Agreement leads to the following result. By arrangement the lender as limited legal owner receives the dividends and obtains a rebate under section 46. The lender then must account for those dividends to the borrower. However, the Investment Agreement allows the lender, in that capacity, to use the dividend money to satisfy the borrower's interest obligations under the arrangement. The dividends on the relevant shares represent assessable income of the borrower under subsection 25(1) or section 97 which, in terms of section 19, the lender has dealt with on behalf of the borrower as agreed under the arrangement.

12. On this basis, the lender derives interest income which is satisfied in part by the amount of dividends received by it and is assessable income under subsection 25(1).

13. There is an alternative reason why the lender would not be entitled to a rebate under section 46. The arrangements considered as a whole lead to the result that the lender receives the dividends on the relevant shares not in its own right but in the capacity of a trustee with the borrower having the beneficial entitlement to the dividends. This trustee relationship arises, inter alia, from a duty to account for the dividends in satisfaction of interest owing which constitutes a beneficial interest of the borrower in the shares. The other benefits of the shares effectively retained by the borrower under the arrangement, such as rights to bonus shares and the ability to direct how the lender votes on the shares, also require the lender to act as a trustee in respect of the shares. The lender receives the dividends as a "trustee" either by operation of the general law of trusts, or because the lender acts as a fiduciary in respect of the dividends.

14. The effect of this is that no section 46 rebate is allowable to the lender as the dividends are included in the net income of a trust estate and not, as required to attract the application of section 46, included in the taxable income of a company. The lender would be assessable on an amount of interest equivalent to the Investment Return. This follows because, under the Investment Agreement, the lender in that capacity retains the dividends to satisfy the interest due under the arrangement as

quantified by the Investment Return.

15. The lender, on an independent basis, can be regarded as having received the dividends in the capacity of an agent for and on behalf of the borrower. A similar line of reasoning to the above would indicate that the lender should be assessed to tax under subsection 25(1) in respect of the Investment Return rather than under section 44 in respect of dividends.

16. Any "management fee" paid to the lender is to be treated as an amount of assessable income characterised as interest. Likewise any excess over the Investment Return that is refunded by the lender to the borrower would be offset as an allowable deduction.

17. It should be noted that section 46D may, in any event, preclude a lender from entitlement to a section 46 rebate in respect of unfranked dividends paid under the above arrangements. Section 46D operates to deny the section 46 rebate on certain dividends paid, in effect, in substitution for payment of interest under financing arrangements. For section 46D to apply to the type of arrangements described, the relevant shares must have been issued after 1pm Australian Eastern Summer Time on 10 December 1986. Having regard to the nature of the arrangements including, in particular, the terms of the Investment Agreement, it is considered that section 46D would have applied in respect of the unfranked part of any "debt dividends" paid in the specific case outlined above if the shares in question had been issued after that time.

18. The anti-avoidance provisions of Part IVA also need to be considered. The non-inclusion of interest in the assessable income of the lender is considered to constitute a tax benefit in terms of paragraph 177C(1)(a) of Part IVA (see Taxation Ruling No.IT 2456).

19. The arrangement described above was formulated on the basis that the lender is entitled to the section 46 rebate in respect of dividends because it is the legal owner of the relevant shares. However, the lender's interest in the shares is circumscribed. The holding of the shares is intended to be for the finance period only. The lender is not to exercise the voting rights in respect of the shares except in accordance with the borrower's instructions; nor can the lender, in the absence of default by the borrower, dispose of the shares. The borrower's approval was also necessary before the lender could accept any bonus issues, options or other rights in respect of the shares. Any bonus issues, etc., so obtained are expressly to be held for the benefit of the borrower. The provision for adjustments to be made between the borrower and lender to ensure that the lender obtains a guaranteed rate of return - and no more - further colours the arrangements.

20. The arrangements, notwithstanding their form, in substance amount to nothing more than a loan from the lender to the borrower. This is confirmed by the financial position of the lender and the borrower in relation to each other that is

evidenced by such things as the Investment Agreement, the security mortgage, the manner in which the Investment Return is calculated and the tax indemnities.

21. The view is taken that, if a transaction has the essential characteristics referred to above, it would be concluded by reference to the matters listed in paragraph 177D(b) that the dominant purpose was to convert what would have been interest income in the hands of the lender - had the arrangements not been implemented in the way that they were - into income in the nature of dividends so as to avoid tax through the dividend rebate.

COMMISSIONER OF TAXATION
23 December 1988