



PR 2007/93 - Income tax: tax consequences of investing in the Westpac Protected Equity Loan

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 This document has changed over time. This is a consolidated version of the ruling which was published on *10 April 2013*



Product Ruling

Income tax: tax consequences of investing in the Westpac Protected Equity Loan

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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, we must apply the law to you in the way set out in the ruling (or in a way that is more favourable for you if we are satisfied that the ruling is incorrect and disadvantages you, and we are 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.

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No guarantee of commercial success

The Tax Office **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.

Potential participants must form their own view about the commercial and financial viability of the product. We recommend 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

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

1. This Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling part apply to the defined class of entities, who participate in the scheme to which this Product Ruling relates.
2. In this Product Ruling this scheme is the grant of a Put Option(s) and the borrowing of moneys, on the terms of a fully protected lending product named the Protected Equity Loan (the PEL) from Westpac Banking Corporation (the Bank). The borrowings are used to acquire shares and/or units (Securities) listed on the Australian Securities Exchange (ASX).
3. This Ruling does not address the tax consequences of:
 - a loan advanced against an existing portfolio of shares;
 - a loan where the Borrower is not also the Owner of the Securities;
 - early repayment or termination of the PEL;
 - repaying the PEL using the limited recourse provisions;
 - using the Top-up Loan;
 - using the Portfolio Adjustment Facility;
 - using the Security Reset Facility; or
 - extending or re-financing the PEL at maturity,

which are available under the terms of the PEL, and described in the Westpac Protected Equity Loan Product Disclosure Statement dated 15 August 2007.

4. This ruling does not address an investor's entitlement to franking credits.

Class of entities

5. The class of entities who can rely on this Product Ruling consists of those entities that are accepted to participate in the scheme specified below on or after the date this Product Ruling is published and which execute the relevant agreements on or before 30 June 2011. They must 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 deriving assessable income from this involvement. These entities are referred to as Investor/s.

Superannuation Industry (Supervision) Act 1993

6. This Product Ruling does not address the provisions of the *Superannuation Industry (Supervision) Act 1993* (SISA 1993). The Tax Office gives no assurance that the product is an appropriate investment for a superannuation fund. The trustees of superannuation funds are advised that no consideration has been given in this Product ruling as to whether investment in this product may contravene the provisions of SISA 1993.

Qualifications

7. The class of entities defined in this Product Ruling may rely on it provided the scheme actually carried out is carried out in accordance with the scheme described in paragraphs 18 to 22 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.

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Date of effect

10. This Product Ruling applies prospectively from 21 November 2007, the date this Ruling is published. It therefore applies to the specified class of entities that enter into the scheme from 21 November 2007 until 30 June 2011, being its period of application. This Product Ruling will continue to apply to those entities even after its period of application for schemes entered into during the period of application.

11. 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;

- it is not later withdrawn by notice in the *Gazette*; or
- the relevant provisions are not amended.

12. If this Product Ruling is inconsistent with a later public or private ruling, the relevant class of entities may rely on either ruling which applies to them (item 1 of subsection 357-75(1) of Schedule 1 to the *Taxation Administration Act 1953* (TAA)).

13. If this Product Ruling is inconsistent with an earlier private ruling, the private ruling is taken not to have been made if, when the Product Ruling is made, the following two conditions are met:

- the income year or other period to which the rulings relate has not begun; and
- the scheme to which the rulings relate has not begun to be carried out.

If the above two conditions do not apply, the relevant class of entities may rely on either ruling which applies to them (item 3 of subsection 357-75(1) of Schedule 1 to the TAA).

Changes in the law

14. Although this Product Ruling deals with the 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 the Ruling and, to that extent, this Product Ruling will have no effect.

15. 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

16. 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 Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Product Ruling is issued.

Ruling

17. Subject to the assumptions in paragraph 22 of this Ruling:
- (a) an amount equal to the interest charged on the PEL, reduced by an amount reasonably attributable to the cost of capital protection worked out under step 3 of the method statement in subsection 247-20(3) of the *Income Tax Assessment Act 1997* (ITAA 1997) or subsection 247-75(1) of the *Income Tax (Transitional*

- Provisions) Act 1997* (IT(TP)A 1997), as applicable, will be deductible under section 8-1 of the ITAA 1997;
- (b) where the Investor enters into the PEL on or after 21 November 2007 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008, under subsection 247-75(1) of the IT(TP)A 1997 the amount reasonably attributable to the cost of capital protection under Division 247 of the IT(TP)A 1997, in an income year, is the amount by which the interest charged on the PEL exceeds the amount of the loan multiplied by the Reserve Bank of Australia's Indicator Lending Rate for Personal Unsecured Loans – Variable Rate (the 'personal unsecured loan rate') at the time when an interest payment is first incurred during the term of the PEL, or the relevant part of the term (subsection 247-75(2) of the IT(TP)A 1997);
- (ba) where the Investor enters into the PEL after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 and on or before 30 June 2011, under subsection 247-20(3) of the ITAA 1997 the amount reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997, in an income year, is the amount by which the interest charged on the PEL exceeds the amount of the loan multiplied by the sum of the Reserve Bank of Australia's Indicator Lending Rate for Standard Variable Housing Loans and 100 basis points (the 'adjusted loan rate') at the time when an interest payment is first incurred during the term of the loan, or the relevant part of the term (subsections 247-20(4) and (5) of the ITAA 1997);
- (c) the amount reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997 or Division 247 of the IT(TP)A 1997, as applicable and as worked out under paragraph 17(b) or 17(ba) of this Ruling, is treated as the cost of the Investor's Put Option (Put Option Premium) under subsection 247-20(6) of the ITAA 1997. The Put Option Premium (if any) is not deductible under section 8-1 of the ITAA 1997;
- (ca) Division 247 of the ITAA 1997 and IT(TP)A 1997 will not apply to the Interest Loan. An amount equal to the interest charged on the Interest Loan will be deductible under section 8-1 of the ITAA 1997;
- (d) section 51AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) will not apply to deny an Investor a deduction for any part of the interest charged on the PEL and the Interest Loan (if applicable) allowable under section 8-1 of the ITAA 1997;

- (e) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest allowable as a deduction under section 8-1 of the ITAA 1997 incurred under the PEL or the Interest Loan (if applicable);
- (f) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the prepaid interest, allowable as a deduction under section 8-1 of the ITAA 1997, incurred under the PEL;
- (g) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility for the prepaid interest on the PEL, allowable under section 8-1 of the ITAA 1997, where at least one of the following applies for the year of income:
- the Investor is a small business entity as defined in subsection 328-110(1) of the ITAA 1997; or
 - the Investor is an individual taxpayer who does not incur the interest charges in carrying on a business,
- (h) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to set the amount and timing of deductions for prepaid interest on the PEL, that is deductible under section 8-1 of the ITAA 1997 to an Investor (other than a small business entity for the year of income), who is a taxpayer that is not an individual and does not carry on a business;
- (i) the Put Option Premium (as described in paragraph 17(c) of this Ruling) will be included in the first element of the cost base (under subsection 110-25(2) of the ITAA 1997) and reduced cost base (under subsection 110-55(2) of the ITAA 1997) of the Put Option;
- (j) if the Put Option is exercised at the end of the PEL term, the Put Option Premium will be included in the cost base and the reduced cost base of the Securities under item 2 in subsection 134-1(1) of the ITAA 1997. Any gain or loss on the exercise of the Put Option will be disregarded by virtue of subsection 134-1(4) of the ITAA 1997;
- (k) if the Put Option is not exercised and it expires, a Capital Gains Tax (CGT) event C2 will happen under section 104-25 of the ITAA 1997. The Investor will make a capital loss at the Maturity Date equal to the reduced cost base of the Put Option;
- (l) the grant of the right under the Reduced Rate Facility by the Investor over Securities is a CGT event which

- does not result in a capital gain or a capital loss to the Investor;
- (m) if the Investor repays the PEL and sells Securities to fund the repayment, a CGT event A1 will happen under section 104-10 of the ITAA 1997. The Investor will make a capital gain on selling the Securities if the sale proceeds are greater than the cost base of the Securities. An investor will make a capital loss if the sale proceeds are less than the reduced cost base of the Securities;
 - (n) if the Bank exercises the right at the Maturity Date, the Cash Settlement Amount will be included in the cost base of the Securities under subsection 110-25(6) of the ITAA 1997;
 - (o) any capital gain realised by an Investor on sale of the Securities will be treated as a discount capital gain pursuant to section 115-5 of the ITAA 1997 where the Investor is an individual or a trust and has held the Securities for at least 12 months;
 - (p) the Loan Establishment Fee paid is deductible under section 25-25 of the ITAA 1997; and
 - (q) the anti-avoidance provisions in Part IVA of the ITAA 1936 will not be applied to deny deductibility of the interest incurred by the Investor in respect of the PEL used to fund the purchase of Securities or in respect of the Interest Loan.

Scheme

18. The scheme that is the subject of this Product Ruling is described below. The scheme is incorporated within the following documents:

- Application for a Product Ruling dated 5 October 2007 submitted by Allens Arthur Robinson on behalf of the Bank; and
- Westpac Protected Equity Loan Product Disclosure Statement (PDS) dated 15 August 2007.

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

19. The PDS highlighted contains the agreements that an Investor may enter into. For the purposes of describing the scheme to which this Product 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. The effect of these agreements is summarised below. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements.

Overview

20. Unless otherwise defined, capitalised terms in this Product Ruling have the same meaning as in the PDS.
21. Following is a summary of the scheme:
 - (a) The PEL is a limited recourse loan product by which Investors borrow funds from the Bank to finance the acquisition of Securities (being either shares or units listed on the ASX). The Securities are selected by an Investor from a range of CHESSE Approved Securities listed in the Term Sheet, or otherwise approved by the Bank.
 - (b) The term of a PEL is 1, 2, 3, 4 or 5 years and the minimum total for all Loan amounts is \$50,000 with additional increments of \$25,000.
 - (c) Investors must pay a Loan Establishment Fee to the Bank upon successful application for a Loan.
 - (d) Under the terms of the PEL, the Bank advances the Investor funds to acquire a Parcel of Securities (the Loan). There is a separate Loan for each Parcel of Securities acquired by an Investor.
 - (e) The Interest Rate on the Loan is fixed for the term of the Loan with different Interest Rates for different Securities.
 - (f) Where an Investor has acquired multiple Parcels of Securities, the Bank may apply a single Interest Rate across the Portfolio. The single Interest Rate will be determined prior to drawdown of the Loans and will be reflective of the type and size of the Parcels of Securities chosen. The single Interest Rate is fixed for the term of the Loans.
 - (g) Interest is payable annually in advance or monthly in arrears and is calculated by applying the applicable Interest Rate to the relevant Loan balance at the beginning of each period. An Investor may elect to change their interest payment method from monthly in arrears to annually in advance and vice versa. The election to change interest payments from annually in advance to monthly in arrears can only be made after the expiry of the relevant prepayment period.
 - (h) Investors may also choose to enter into an Interest Loan with the Bank for the purpose of funding the

payment of prepaid interest on a PEL. The term of each Interest Loan is limited to 12 months. The interest rate on an Interest Loan will be a fixed rate determined by the Bank, and may be different to the Interest Rate on the related Loan. The Interest Loan is repayable in one amount at the Interest Loan Maturity Date. Under the Interest Loan, there is no limitation on the recourse of the lender.

- (i) For the purpose of securing the rights of the Bank under the PEL, the Investor grants a mortgage to the Bank over the acquired Securities and related rights (the Secured Property).
- (j) In the event of Default at the Maturity Date, where an Investor fails to repay the Loan, the Bank's recourse under each Loan is limited to the relevant Secured Property but is not limited in respect of any other default by an Investor.
- (k) Investors are granted a Put Option under which the Investor may sell the Securities for the outstanding amount of the Loan at the Maturity Date.
- (l) The Investor is not required to pay a separate fee for the Put Option, rather a portion of the interest payable under the PEL is allocated to the Put Option Premium. The Put Option Premium will be determined in accordance with paragraph 17(b) or 17(ba) of this Ruling and will vary depending on the term of the PEL.
- (m) The Bank may allow Investors to utilise a Reduced Rate Facility in relation to a Parcel of Securities under which:
 - (i) the Investor grants the Bank a right entitling the Bank to receive the Cash Settlement Amount if, at the Maturity Date of the Loan relating to that Parcel, the Market Value of the Securities exceeds the Cap Price chosen by the Investor (which will be greater than the outstanding Loan amount);
 - (ii) no amount is payable by the Bank to an Investor for the right, instead the Investor will be charged a lower rate of interest in respect of the Loan relating to that Parcel of Securities than would apply if no right was granted;
 - (iii) if the Bank exercises its right at the Maturity Date, the Investor must cash settle the right by paying the Bank the Total Amount Owing in respect of the Loan relating to that Parcel of Securities and the Cash Settlement Amount. The Cash Settlement Amount equals the sum of the excess of the Market Value of the

Securities over the Cap Price or, if a Participation Rate has been nominated, the excess of the Market Value over the Cap Price less the amount determined by multiplying the Participation Rate by that excess.

- (n) At the Maturity Date of a Loan, unless the Bank exercises a right as described at paragraph 21(m) of this Ruling, an Investor may:
- (i) keep the Parcel of Securities and repay the Loan using their own funds;
 - (ii) sell the Parcel of Securities at the prevailing market price, apply the sale proceeds to repay the Loan and keep any surplus;
 - (iii) elect to exercise the Put Option to sell the Securities for the outstanding Loan Amount (note that if the market value of the Parcel of Securities is less than the outstanding Loan Amount, the Put Option will be exercised automatically); or
 - (iv) do nothing, in which case the Bank will act under the Mortgage to take possession of the Securities and recover what it can from the sale of those Securities as repayment or reduction of the Loan principal outstanding.
- (o) As the legal and beneficial owner of the Securities, Investors will be entitled to all dividends, trust distributions and capital gains. However, any of the following in relation to the Securities must be held in an account opened by the Bank on the Investor's behalf (the Deposit Account):
- (i) cash returns on capital;
 - (ii) Special Dividends;
 - (iii) proceeds from the disposal or relinquishment of rights; and
 - (iv) proceeds in relation to options granted to or by the Security Owner.

The Deposit Account is solely for the purposes of the PEL and cannot be operated by the Investor.

- (p) Brokerage, Taxes, costs, charges and commissions (if any) in relation to the purchase and sale of Securities, and the preparation of the PEL documentation, including any stamp duty and brokerage fees, are payable by the Investor.

Assumptions

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

- (a) the Investors are Australian residents for taxation purposes;
- (b) the Investors are not traders in investments and would not be treated for taxation purposes as either trading in the Securities, carrying on a business of investing in the Securities or holding the Securities as trading stock or as a revenue asset;
- (c) any interest charges to be paid in advance under a PEL which are prepaid relate to a loan interest payment period of 12 months or less that ends on or before the last day of the income year following the expenditure year;
- (d) the dominant purpose of an Investor entering into the Scheme is to derive assessable income from their investment in the Securities comprising dividends or trust distributions and capital gains;
- (e) at all times during the arrangement, where the Securities include units in a trust, the trust satisfied the requirements of subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;
- (f) the Scheme ruled on will be executed in the manner described in the Scheme section of this Ruling; and
- (g) all dealings by the Investors and the Bank under the PEL will be at arm's length;
- (h) neither the Loan or the Interest Loan will extend beyond their original Maturity Dates; and
- (i) the Investor will not repay the Loan or the Interest Loan early or terminate the Scheme early.

Commissioner of Taxation21 November 2007

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 8-1 and Division 247

23. The interest paid on a borrowing used to acquire income producing assets such as shares or units in a unit trust is generally treated as deductible under section 8-1 of the ITAA 1997 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

24. Division 247 of the ITAA 1997 applies to a PEL because it is a capital protected borrowing, as:

- the Investor uses the Loan from the Bank to acquire a beneficial interest in a Parcel of Securities comprising of shares, or units in a unit trust; and
- the Investor is protected against the fall in market value of the Parcel of Securities.

25. Division 247 of the IT(TP)A 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a capital protected borrowing entered into on or after 21 November 2007 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008. Division 247 of the IT(TP)A 1997 ignores any amount which is not in substance for capital protection or interest in calculating the cost of capital protection, pursuant to subsection 247-75(1) of the IT(TP)A 1997.

25A. Division 247 of the ITAA 1997 sets out a methodology for reasonably attributing the cost of capital protection incurred by a borrower under a capital protected borrowing entered into after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008. Division 247 of the ITAA 1997 ignores any amount which is not in substance for capital protection or interest in calculating the cost of capital protection, pursuant to subsection 247-20(3) of the ITAA 1997.

26. Under the PEL, the amount reasonably attributable to the cost of capital protection is worked out under the method statement in subsection 247-75(1) of the IT(TP)A 1997 or subsection 247-20(3) of the ITAA 1997, as applicable and as set out in paragraph 17(b) or 17(ba) of this Ruling.

27. As there is no separate charge payable by an Investor in a PEL for the Put Option, the cost of the Investor's Put Option (if any), for the purposes of Division 247 of the ITAA 1997, is only that amount worked out under subsection 247-20(3) of the ITAA 1997 or subsection 247-75(1) of the IT(TP)A 1997, as applicable (subsection 247-20(6) of the ITAA 1997). This amount is referred to as the Put Option Premium.

28. For an Investor in a PEL, the Investor's Put Option is a capital asset. As the Put Option Premium is the cost of the Investor's Put Option, this expense is capital in nature and is not deductible. The interest charged on the PEL will be deductible under section 8-1 of the ITAA 1997 only to the extent that it does not constitute the Put Option Premium.

29. Where an Investor has acquired multiple Parcels of Securities and the Bank has applied a single Interest Rate across the Portfolio, the investment will constitute one arrangement for Division 247 of the ITAA 1997 purposes. However, as there is a separate Put Option provided in respect of each of the Parcels of Securities in the Portfolio, the Investor's Put Option Premium will need to be reasonably apportioned to each Put Option having regards to the size of each of the Parcels of Securities.

Section 51AAA

30. Under the PEL it is contemplated that over a period of an Investor's involvement there will be assessable income derived by way of dividend income or trust income as well as by way of capital gain. As the interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a capital gain, section 51AAA of the ITAA 1936 has no application to an Investor in the PEL.

Section 82KL

31. The operation of section 82KL of the ITAA 1936 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 of the ITAA 1936. It will not apply to deny the deductions otherwise allowable under section 8-1 of the ITAA 1997.

Subdivision H of Division 3 of Part III

32. Subdivision H of Division 3 of Part III (Subdivision H) of the ITAA 1936 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 a small business entity, whether the Investor is an individual and whether the Investor is not an individual and incurs the expenditure otherwise than in carrying on a business. This Subdivision does not apply to 'excluded expenditure' which is defined in subsection 82KZL(1) of the ITAA 1936 to include amounts of less than \$1,000 or amounts that are of a capital nature.

Subdivision 328-C: small business entities

33. An Investor will be a small business entity for an income year if the Investor carries on a business and either:

- the Investor carried on a business in the previous income year and the Investor's aggregated turnover for the previous year was less than \$2 million; or
- the Investor's aggregated turnover in the current income year is likely to be less than \$2 million.

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

34. The interest charge on the PEL allowable under section 8-1 of the ITAA 1997 is, if paid in advance, in relation to a prepayment of loan interest for a period that is 12 months or less.

Paragraph 82KZL(2)(a) of the ITAA 1936 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 of the ITAA 1936, 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, and not to the period of the PEL.

Sections 82KZME and 82KZMF: prepaid expenditure and 'tax shelter' type arrangements

35. The rules in sections 82KZME of the ITAA 1936 and 82KZMF of the ITAA 1936 apply, subject to the exceptions in section 82KZME, where expenditure is incurred in relation to a 'tax shelter' scheme for the doing of a thing that is not to be wholly done within the expenditure year.

36. For the purposes of section 82KZME of the ITAA 1936, 'agreements' are broadly defined to include an entire scheme of which a contract may form part. Under subsection 82KZME(4) of the ITAA 1936, the relevant 'agreement' is all the contractual schemes and activities associated with the participation in the PEL, including the financing, share and/or unit acquisition, and share and/or unit disposal arrangements.

37. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936, applies to exclude the amount allowable for interest on borrowings under the PEL from the operation of section 82KZMF of the ITAA 1936, as:

- the prepaid interest expenditure under the PEL is incurred in respect of money borrowed to acquire Securities that are listed for quotation on the ASX or units in a unit trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936;

- the Investor can reasonably be expected to obtain dividends or trust income from the investment;
- the Investor will not obtain any other kind of assessable income from the investment, except for capital gains; and
- all aspects of the PEL are at arm's length.

38. Deductibility of the prepaid interest must therefore be considered under the prepayment rules contained in paragraphs 39 to 44 of this Ruling.

Section 82KZM: prepaid expenditure incurred by small business entities and individuals incurring non-business expenditure

39. Section 82KZM of the ITAA 1936 operates to spread over more than one income year, a deduction for prepaid expenditure incurred by a taxpayer that is either:

- a small business entity for the year of income; or
- a taxpayer that is an individual and the expenditure is not incurred in carrying on a business.

40. The expenditure must not be excluded expenditure and must be incurred otherwise than in carrying on a business. Section 82KZM of the ITAA 1936 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 under section 8-1 of the ITAA 1997.

41. As the eligible service period in relation to the deductible interest payment under the PEL is not more than 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 of the ITAA 1936 will have no application to Investors who are small business entities for the year of income, or to Investors who are individuals where 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 interest allowable under section 8-1 of the ITAA 1997 incurred under the PEL.

Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by non-individual and non small business entities

42. Sections 82KZMA and 82KZMD of the ITAA 1936 set the amount and timing of deductions for expenditure for an Investor (other than a small business entity for the year of income) who is an Investor that is not an individual and does not incur the expenditure in carrying on a business.

43. The expenditure must not be excluded expenditure and 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.

44. For these taxpayers, the amount allowable for prepaid interest allowable as a deduction under section 8-1 of the ITAA 1997 incurred on the PEL will be apportioned over the relevant interest payment period.

Put Option and Cost Base

45. The Put Option Premium is not deductible to the Investor under section 8-1 of the ITAA 1997 (refer to paragraphs 17(b), 17(ba), 17(c) and 28 of this Ruling) and is included in the cost base and reduced cost base of the Put Option(s) acquired by the Investor pursuant to subsection 110-25(2) and subsection 110-55(2) of the ITAA 1997 respectively. The Put Option constitutes an asset for CGT purposes and is separate and in addition to the other rights created under the PEL as described in this Ruling.

46. If the Put Option is exercised at the end of the PEL term by transferring title to the Securities to the Bank in satisfaction of the Loan, any gain or loss on exercise of the Put Option is disregarded (subsection 134-1(4) of the ITAA 1997). The Investor will include the Put Option Premium in the second element of the cost base and reduced cost base of the Securities disposed to the Bank (item 2 of subsection 134-1(1), of the ITAA 1997).

47. If the Put Option is not exercised by the end of the PEL term it expires and the Investor will make a capital loss at that time, equal to the reduced cost base of the Put Option (CGT Event C2, paragraph 104-25(1)(c) of the ITAA 1997).

Reduced Rate Facility

48. Under the Reduced Rate Facility, the Investor grants a right to the Bank which may be exercised if the Market Value of the Securities on the Maturity Date is greater than the Cap Price that is chosen by the Investor.

49. The grant of a right by the Investor to the Bank under the Reduced Rate Facility is a CGT event which will not result in a capital gain or loss arising for the Investor.

50. If the Bank exercises the right, no CGT event will arise in respect of the Securities that have been retained by the Investor in these circumstances. The amount paid by the Investor, that is the Cash Settlement Amount, is capital expenditure made to preserve the Investor's title to the Securities and will form part of the Investor's cost base in the Securities (subsection 110-25(6) of the ITAA 1997). The Cash Settlement Amount equals the sum of the excess of the Market Value of the Securities over the Cap Price or, if a Participation Rate has been nominated, the excess of the Market Value over the Cap Price less the amount determined by multiplying the Participation Rate by that excess.

Section 115-5: CGT discount

51. Division 115 of the ITAA 1997 allows a taxpayer a discount on capital gains in certain circumstances. Under section 115-5 of the ITAA 1997, any capital gain realised by an Investor from the transfer of Securities to the Bank at maturity will be treated as a discount capital gain where the Investor is an individual or a trust and has held the Securities for at least 12 months.

Section 25-25: Loan Establishment Fee

52. The Loan Establishment Fee incurred by an Investor upon successful application for a Loan will be an allowable deduction pursuant to section 25-25 of the ITAA 1997 because it is a cost of borrowing money which is used for the purpose of producing assessable income. The Loan Establishment Fee will be deductible on a straight line basis over the period of the shorter of:

- the term of the Loan; or
- five years.

Part IVA

53. Provided that the scheme ruled on is entered into and carried out as disclosed (see the Scheme part 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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Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 95/33

Subject references:

- debt deductions
- financial products
- interest expense
- prepaid expenses
- product rulings

Legislative references:

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- ITAA 1936 82KL
- ITAA 1936 Pt III Div 3 Subdiv H
- ITAA 1936 82KZL(1)
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- ITAA 1936 82KZM
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