



# ***PR 2008/6 - Income tax: tax consequences of investing in the UBS Protected Geared Investment - 2007 Product Disclosure Statement***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *8 May 2013*



## Product Ruling

# Income tax: tax consequences of investing in the UBS Protected Geared Investment – 2007 Product Disclosure Statement

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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.

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

## No guarantee of commercial success

The 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

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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 Ruling sets out the Commissioner's opinion on the way in which the relevant provision(s) identified in the Ruling section apply to the defined class of entities, who participate in the scheme to which this Product Ruling relates. In this Ruling the scheme is the borrowing of moneys on limited recourse terms to fund the acquisition of shares that are listed for quotation on the Australian Securities Exchange (ASX), and/or units in a unit trust as described in subparagraph 82KZME(5)(b)(iii) of the *Income Tax Assessment Act 1936* (ITAA 1936) referred to in this Product Ruling as 'Approved Securities', on the terms of a lending investment known as the 'UBS Protected Geared Investment Product', which is referred to in this Product Ruling as the 'PGI'.

2. This Ruling does not address the tax consequences of the following features:

- the Share Roll-In Facility;
- the Loan Extension Facility;
- extending the Protected Loan at maturity;
- the Trading Facility; and
- the Stock Switch Facility,

which are available under the terms of the PGI and described in the Product Disclosure Statement. Paragraph 17 of this Ruling will apply to an Investor up to the time that the Investor uses one or more of the features listed in paragraph 2 of this Ruling.

3. This Ruling does not address an investor's entitlement to franking credits.

### Class of entities

4. 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 relevant agreements mentioned in paragraph 18 of this Ruling 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**

5. 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**

6. 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 21 of this Product Ruling.

7. 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**

9. This Product Ruling applies prospectively from 30 January 2008, the date this Ruling is published. It therefore applies to the specified class of entities that enter into the scheme from 30 January 2008 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.

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

11. 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)).

12. 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.

13. 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.

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## Ruling

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17. Subject to the assumptions in paragraph 22 of this Ruling:
- (a) an amount equal to the interest incurred on the Protected Loan in an income year, reduced by an amount reasonably attributable to the cost of capital protection 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 PGI on or after 30 January 2008 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 that is reasonably attributable to the cost of capital protection under Division 247 of the IT(TP)A 1997 in an income year will be the amount by which the interest incurred on the Protected Loan exceeds an amount representing the interest that would have been incurred in an income year if the Reserve Bank of Australia's Indicator Lending Rate for Personal Unsecured Loans – Variable Rate (the 'personal unsecured loan rate') at the time when the first interest payment is incurred during the term of the loan, or the first interest payment is incurred for the relevant part of the term of the loan, had been applied (subsection 247-75(2) of the IT(TP)A 1997);
  - (ba) where the Investor enters into the PGI 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 that is reasonably attributable to the cost of capital protection under Division 247 of the ITAA 1997 in an income year will be the amount by which the interest incurred on the Protected Loan exceeds an amount representing the interest that would have been incurred in an income year if 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 the first interest payment is incurred during the term of the loan, or the first interest payment is incurred for the relevant part of the term of the loan, had been applied (subsections 247-20(4) and (5) of the ITAA 1997);

- (bb) Division 247 of the ITAA 1997 and IT(TP)A 1997 will not apply to the Interest Funding Loan. An amount equal to the interest expense incurred on the Interest Funding Loan will be deductible under section 8-1 of the ITAA 1997;
- (c) section 51AAA of the ITAA 1936 will not apply to deny an Investor a deduction of the interest charge on the Protected Loan and Interest Funding Loan (if applicable) allowable under section 8-1 of the ITAA 1997;
- (d) section 82KL of the ITAA 1936 will not apply to deny deductibility of the interest charge on the Protected Loan and Interest Funding Loan (if applicable) allowable under section 8-1 of the ITAA 1997;
- (e) section 82KZMF of the ITAA 1936 will not apply to set the amount and timing of deductions for the prepaid interest charge on the Protected Loan and Interest Funding Loan (if applicable);
- (f) section 82KZM of the ITAA 1936 will not apply to deny the Investor immediate deductibility for the prepaid interest charge on the Protected Loan and Interest Funding Loan (if applicable) allowable under section 8-1 of the ITAA 1997 where at least one of the following applies for the year of income:
  - (i) the Investor is a small business entity that does not elect for section 82KZMD to apply; or
  - (j) the Investor is an individual who does not incur the expenditure in carrying on a business,
- (g) sections 82KZMA and 82KZMD of the ITAA 1936 will apply to determine the amount and timing of deductions for the prepaid interest charge on the Protected Loan and Interest Funding Loan (if applicable) that is deductible to an Investor (other than a small business entity that does not elect for section 82KZMD of the ITAA 1936 to apply) who is a taxpayer that is not an individual and does not carry on a business;
- (h) the grant of the Call Option by the Investor to UBS under the Call Sale Facility is a CGT event D2 under section 104-40 of the ITAA 1997 which does not result in a capital gain or a capital loss;
- (i) if UBS exercises the Call Option and the Investor transfers the Approved Securities to it, CGT event A1 will occur. The Investor will make a capital gain or capital loss equal to the capital proceeds received from UBS less the cost base or reduced cost base of the Approved Securities. The capital proceeds received by

- the Investor will be equal to the Settlement Amount, being the Capped Amount plus the percentage that the Investor has elected to retain of the capital growth of the Approved Securities above the Capped Amount;
- (j) if UBS exercises its Call Option and the Investor pays the Cash Settlement Amount the Investor will be able to retain ownership of the Approved Securities. The Cash Settlement Amount will be included in the cost base and reduced cost base of the Approved Securities under subsection 110-25(6) of the ITAA 1997;
  - (k) the part of the interest incurred on the Protected Loan that is reasonably attributable to the cost of capital protection as determined in accordance with paragraph 17(b) or 17(ba) of this Ruling will be treated as having been incurred for a notional put option granted by UBS under the scheme under section 247-20 of the ITAA 1997..That amount will be included in the first element of the cost base and reduced cost base of the notional put option under subsections 110-25(2) and 110-55(2) of the ITAA 1997;
  - (l) for CGT purposes, the date that an Investor acquires the Approved Securities is the Drawdown Date;
  - (m) if the capital protection under the PGI is invoked and the Investor disposes of the Approved Securities, the notional put option referred to in paragraph 17(k) of this Ruling will be treated under subsection 247-30(1) of the ITAA 1997 as having been exercised and the cost base of the notional put option will be included in the second element of the cost base and reduced cost base of the Approved Securities under subsections 110-25(3) and 110-55(3), pursuant to section 134-1 of the ITAA 1997. Any gain or loss on the exercise of the notional put option will be disregarded by virtue of subsection 134-1(4) of the ITAA 1997;
  - (n) if the capital protection under the PGI is not invoked, the notional put option referred to in paragraph 17(k) of this Ruling will be treated under subsection 247-30(2) of the ITAA 1997 as not having been exercised. CGT event C2 will occur under section 104-25 of the ITAA 1997 on the Maturity Date. The capital proceeds received on expiration of the notional put option will be nil under section 116-20 of the ITAA 1997. The Investor will make a capital loss equal to the reduced cost base of the notional put option under subsection 104-25(3) of the ITAA 1997;



- (o) if the Investor sells the Approved Securities to repay the Protected Loan and Interest Funding Loan (if applicable), CGT event A1 will happen under section 104-10 of the ITAA 1997. The Investor will make a capital gain or capital loss on selling the Approved Securities equal to the sale proceeds less the cost base or reduced cost base of the Approved Securities;
- (p) any capital gain realised by an Investor on sale of the Approved 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 Approved Securities for at least 12 months;
- (q) the commercial debt forgiveness rules in Schedule 2C of the ITAA 1936 will not reduce the tax attributes of an Investor in relation to any debt forgiveness that arises because of the limited recourse nature of the Protected Loan; and
- (r) the anti-avoidance provisions contained 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 Protected Loan and the Interest Funding Loan (if applicable).

## **Scheme**

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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 received from Clayton Utz on behalf of UBS on 5 November 2007;
- Master Document for the Protected Geared Investment (the 'Master Document'), prepared and issued by UBS, dated 24 August 2007;
- UBS Protected Geared Investment Loan Agreement (the 'Loan Agreement'), which forms part of the Master Document, prepared and issued by UBS;
- Example Protected Geared Investment Term Sheet (the 'Example Term Sheet') which incorporates the Example Protected Geared Investment Portfolio Selection sheet, as amended, prepared and issued by UBS dated 2 October 2007;
- Draft Example Confirmation Notice (the 'Example Confirmation'), prepared by UBS, draft dated 14 September 2007; and

- Additional information received from Clayton Utz on behalf of UBS on 18 January 2008.

**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 documents highlighted are those 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.

20. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. The effect of these agreements is summarised as follows.

### **Overview**

21. Unless otherwise defined, capitalised terms in this Product Ruling have the same meaning as in the scheme documents listed in paragraph 18 of this Ruling. Following is a summary of the scheme:

- (a) each Investor will enter into a Loan Agreement with UBS. The PGI involves the making of a limited recourse loan by UBS to an Investor for a fixed term of one, two, three, four or five years (at the Investors option). The term will commence on the issue date agreed between the Investor and UBS. Although the issue date (and therefore the Maturity Date) will not necessarily be the same for all Investors in the PGI, each Investor's loan will have a term of one, two, three, four or five years;
- (b) the funds provided under the loan are used to finance the purchase price of one or more Approved Securities to be acquired by the Investor. The Approved Securities will be shares listed on the ASX and/or units in a unit trust as described in subparagraph 82KZME(5)(b)(iii) of the ITAA 1936. UBS will offer Investors a choice of Approved Securities. An Investor may choose to invest in a single Approved Security or in a number of Approved Securities;
- (c) where there is more than one Approved Security the loan is segmented into tranches comprising the amount applied to purchase each tranche of Approved Securities acquired by the Investor;
- (d) UBS may offer a further loan to Investors to fund part of the payment of the interest payable on the Protected Loan (the 'Interest Funding Loan'). Availability of the

Interest Funding Loan will be specified in the applicable term sheet (or may be agreed with UBS) and is subject to credit approval by UBS. The Interest Funding Loan will be a full-recourse loan, with principal repayable over a two year period in the case of a PGI having a three year term, and over a three year period in the case of a PGI with a four or five year term.

Interest on an Interest Funding Loan is payable at the start of each interest payment period (which coincides with the interest payment periods under the Protected Loan) during the term of the Interest Funding Loan, at the interest rate set out in the Investor's Confirmation;

- (e) the Protected Loan and the Interest Funding Loan (if applicable) are secured by a mortgage in favour of UBS over the Approved Securities and any distributions paid on the Approved Securities;
- (f) the Protected Loan provided by UBS to the Investor is a 'limited recourse' loan. Under the terms of the Loan Agreement, UBS's ability to recover the principal amount of the Protected Loan is limited to the amount that UBS is able to obtain by enforcing its rights in respect of the mortgaged property;
- (g) in all other respects, including in relation to any Interest Funding Loan, UBS's recourse against an Investor will not be limited;
- (h) Protected Loans may be either 'fixed rate loans' or 'variable rate loans':
  - (i) interest on a 'fixed rate loan' will be paid at a fixed rate for all of the term of the Protected Loan (being the rate per interest payment period agreed with UBS, and confirmed in the Investor's Confirmation). That is, the same interest rate applies to each interest payment period throughout the whole term of the Protected Loan. Interest on a fixed rate loan will be prepaid for each interest payment period. Generally, the interest payment periods will be periods of approximately 1 year (or possibly shorter in the case of the first and last periods) approximately coinciding with the financial year (or part thereof);
  - (ii) interest on a 'variable rate loan' will be paid at a fixed rate for each interest payment period, being each period of approximately 1 year (or possibly shorter in the case of the first and last periods) during the term of the Protected Loan approximately coinciding with the financial year (or part thereof). The rate for each period will be determined by reference to prevailing market

interest rates at the beginning of the period. Each interest payment will generally be prepaid annually, or, where UBS agrees, may be paid in monthly instalments over the duration of the interest payment period. The rate per interest payment period will be confirmed in the Investor's Confirmation;

- (i) for each Interest Funding Loan (where applicable), interest will generally be prepaid annually at a fixed rate determined at the beginning of the term of the Interest Funding Loan;
- (j) the terms of the Loan Agreement allow an Investor to choose to cap the capital growth on the Approved Securities under the 'Call Sale Facility'. The Call Sale Facility involves the Investor writing an option (the 'Call Option') to UBS to purchase the Approved Securities at expiry of the Call Option (which may be on or before the Protected Loan repayment date) if the market value of the Approved Securities at that time is equal to or exceeds the 'Capped Amount' chosen by the Investor (being a percentage greater than 100% of the protected price of the Approved Securities). The Investor may grant a Call Option over one or more tranches of Approved Securities. The Investor's election to use the Call Sale Facility is irrevocable;
- (k) under the Call Sale Facility, Investors may also elect to retain, and therefore share with UBS, part of the capital growth of the Approved Securities above the Capped Amount. The percentage of capital growth of the Approved Securities above the Capped Amount that the Investor chooses to retain is the 'Participation Rate';
- (l) no fee is payable to the Investor for the grant of the Call Option to UBS. However, if the Investor elects to use the Call Sale Facility, the interest payable by the Investor on the Protected Loan and the Interest Funding Loan (if applicable) will be reduced. The reduction in the interest rate will depend on the level of the Capped Amount and the Participation Rate applicable;
- (m) where UBS exercises its Call Option, the amount payable by UBS to the Investor to acquire the Approved Securities will be the sum of the Capped Amount and the Participation Rate multiplied by the capital growth of the Approved Securities above the Capped Amount (the 'Settlement Amount');
- (n) alternatively, where UBS exercises its Call Option, the Investor may elect to pay UBS the amount of UBS's share of the capital growth on the Approved Securities

above the Capped Amount (the 'Cash Settlement Amount'), and retain the Approved Securities;

- (o) on maturity of the PGI, an Investor who has not used the Call Sale Facility has three alternatives:
  - (i) repay the Protected Loan and Interest Funding Loan (if applicable) from their own funds (which will result in a release of the mortgage over the Approved Securities);
  - (ii) extend the Protected Loan for a further fixed term (if UBS makes this option available to the Investor) subject to the consent of UBS;
  - (iii) if neither of the above apply UBS may proceed to exercise its rights as mortgagee of the mortgaged property, and distribute surplus disposal proceeds, if any, to the Investor after repayment of the Protected Loan and the Interest Funding Loan (if applicable) and any costs and expenses;
- (p) the alternatives available on maturity to an Investor who has used the Call Sale Facility will depend on the market value of the Approved Securities at maturity. Where the market value of the relevant Approved Securities is less than the Capped Amount, UBS will not exercise the Call Option, and the alternatives outlined in paragraph 21(o) of this Ruling will be available to the Investor. Where the market value of the Approved Securities is equal to or greater than the Capped Amount such that the Call Option is exercised, the following three alternatives are available to the Investor:
  - (i) sell the Approved Securities to UBS pursuant to the Call Option, with the Settlement Amount applied to repay the Protected Loan, the Interest Funding Loan (if applicable) and any costs and expenses (resulting in a release of the mortgage), with any surplus proceeds distributed to the Investor;
  - (ii) repay the Protected Loan and the Interest Funding Loan (if applicable) from the Investor's own funds and pay the Cash Settlement Amount to UBS (which will result in a release of the mortgage over the Approved Securities and the Investor retaining the Approved Securities); and
  - (iii) extend the Protected Loan for a further fixed term (if UBS makes this option available to the Investor, and subject to UBS's consent) and pay the Cash Settlement Amount to UBS;

- (q) the Investor may repay part or all of the Protected Loan and the Interest Funding Loan (if applicable) prior to the maturity of that loan. If this occurs, the Investor may be liable for break fees to cover any costs incurred by UBS as a result of the early unwinding of the PGI;
- (r) any distributions paid to the Investor in respect of the Approved Securities will either be passed directly on to the Investor or will be held for the Investor by UBS or its nominee. Where distributions are held on the Investor's behalf, the Loan Agreement provides that such amounts may be used towards payment of the Investor's interest obligations to UBS. Any distributions remaining after an interest payment date may be released to the Investor. Where the Investor has an outstanding Interest Funding Loan, such amounts may be applied towards payment of principal and interest on the Interest Funding Loan.

### **Assumptions**

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

- (a) all of the Investors are Australian residents for taxation purposes;
- (b) the Investors are not traders in investments and are not treated for taxation purposes as trading in the Approved Securities, carrying on a business of investing in the Approved Securities, or holding the Approved Securities as trading stock or as revenue assets;
- (c) the Investors' purpose in investing in the PGI will be to invest in the Approved Securities so as to derive assessable income comprising dividends or trust distributions, and capital gains on the sale of the Approved Securities on or after maturity of the PGI;
- (d) neither UBS nor any related bodies corporate will be allowed to invest in the PGI;
- (e) the scheme will be executed in the manner described in the Scheme section of this Ruling; and
- (f) all dealings by the Investors and UBS under the PGI will be at arm's length.

## 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: deductibility of interest**

23. 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 assessable income would be derived from the investment (see Taxation Ruling TR 95/33).

24. Division 247 of the ITAA 1997 applies to the PGI as a capital protected borrowing (CPB) because the Investor uses the borrowing to acquire Approved Securities (being shares, units of a unit trust, and/or stapled securities), and the Investor is protected against a fall in the market value of the Approved 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 CPB entered into on or after 30 January 2008 but at or before 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 (section 247-75 of the IT(TP)A 1997). 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 (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 CPB entered into after 7.30 pm by legal time in the Australian Capital Territory on 13 May 2008 (section 247-20 of the ITAA 1997). 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 (subsection 247-20(3) of the ITAA 1997).

26. Under the PGI, the amount reasonably attributable to the cost of capital protection is worked out according to 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. This amount is treated as the cost of the Investor's notional put option under subsection 247-20(6) of the ITAA 1997.

27. Under step 1 of the method statement, the total amount incurred by the Investor under or in respect of the CPB for the income year is the interest incurred on the Protected Loan for the income year.

28. Where the total amount incurred by the Investor in step 1 of the method statement is less than the total interest that would have been incurred by the Investor worked out under step 2 of the method statement, there is no amount reasonably attributable to the cost of capital protection. In these circumstances all of the interest incurred

on the Protected Loan will be deductible under section 8-1 of the ITAA 1997.

29. Where the total amount incurred by the Investor in step 1 of the method statement is greater than the total interest that would have been incurred by the Investor worked out under step 2 of the method statement, the excess amount is reasonably attributable to the cost of capital protection and is treated as if it were incurred only for a notional put option under Division 247 of the ITAA 1997. The notional put option is a capital asset for an Investor in the PGI. As the amount reasonably attributable to the cost of capital protection is the cost of the Investor's notional put option, this expense is capital in nature. The interest charged on the Protected Loan will therefore only be deductible under section 8-1 of the ITAA 1997 to the extent that it is not reasonably attributable to the cost of capital protection.

29A. There is no element of capital protection connected with the Interest Funding Loan. No part of the interest incurred by the Investor on the Interest Funding Loan for the income year will therefore be attributable to the cost of capital protection.

### **Section 51AAA**

30. By entering into the PGI it is contemplated that an Investor will derive assessable income by the receipt of dividends or trust income and capital gains. As the interest would have been deductible under section 8-1 of the ITAA 1997 notwithstanding the inclusion of a net capital gain in assessable income, section 51AAA of the ITAA 1936 has no application to an Investor in the PGI.

### **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. Section 82KL of the ITAA 1936 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. Subdivision H of the ITAA 1936 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 of expenditure that are of a capital nature.

### ***Subdivision 328-C: small business entity***

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. That part of the total interest incurred on the Protected Loan and, if applicable, the Interest Funding Loan (the 'Total Amount') allowable as a deduction under section 8-1 of the ITAA 1997 is 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 purpose 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 loan.

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

35. The rules in sections 82KZME and 82KZMF of the ITAA 1936 apply, subject to the exceptions in section 82KZME of the ITAA 1936, where expenditure is incurred in relation to a 'tax shelter' arrangement 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 arrangement of which a contract may form a part. Under subsection 82KZME(4) of the ITAA 1936, the relevant 'agreement' is all the contractual arrangements and activities associated with the participation in the PGI, including the financing, purchase, holding and disposal arrangements.

37. Exception 1, as contained in subsection 82KZME(5) of the ITAA 1936 applies to exclude that part of the Total Amount that is allowable as a deduction under section 8-1 of the ITAA 1997 incurred

on the Protected Loan and the Interest Funding Loan (if applicable), from the operation of section 82KZMF of the ITAA 1936 as:

- that part of the prepaid interest allowable as a deduction under section 8-1 of the ITAA 1997 is incurred in respect of money borrowed to acquire shares that are listed for quotation on the ASX and/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 dividend 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 PGI are at arm's length.

38. Deductibility of expenditure must therefore be considered under the prepayment rules outlined 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 that does not elect for section 82KZMD of the ITAA 1936 to apply; 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 that part of the Total Amount allowable as a deduction under section 8-1 of the ITAA 1997 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 that do not elect for section 82KZMD of the ITAA 1936 to apply, or to Investors who are individuals and the expenditure is not incurred in carrying on a business. Investors who satisfy these tests will be able

to claim an immediate deduction for that part of the Total Amount allowable as a deduction under section 8-1 of the ITAA 1997.

***Sections 82KZMA and 82KZMD: prepaid non-business expenditure incurred by non-individuals 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 that does not elect for section 82KZMD of the ITAA 1936 to apply) 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 doing a thing under an agreement that is not wholly done within the expenditure year.

44. For these Investors, the deduction for prepaid interest allowable under section 8-1 of the ITAA 1997 will be apportioned over the relevant interest payment period.

**Call Sale Facility**

45. Under the PGI, the Investor may, either on application or, at UBS's discretion, use the Call Sale Facility. This involves the Investor granting to UBS a Call Option to purchase the Approved Securities at expiry of the Call Option. The Call Option will be exercised if the market value of the Approved Securities at expiry of the Call Option is equal to or greater than the Capped Amount that is chosen by the Investor.

46. If the Call Option is exercised, the Investor is required to transfer the Approved Securities to UBS for the Settlement Amount or cash settle the Call Option obligations by paying the Cash Settlement Amount.

47. The grant of the Call Option by the Investor to UBS will be a CGT event D2 under section 104-40 of the ITAA 1997 that will not result in a capital gain or capital loss arising for the Investor.

48. Where the Investor chooses to sell the Approved Securities to UBS, CGT event A1 will occur in relation to the disposal of the Approved Securities (section 104-10 of the ITAA 1997). Where the capital proceeds of the disposal exceed the Investor's cost base of the Approved Securities, the Investor will make a capital gain.

49. The capital proceeds the Investor receives when they sell their Approved Securities to UBS pursuant to the Call Option will be the Settlement Amount, being the sum of the Capped Amount and the percentage of capital growth of the Approved Securities above the Capped Amount that the Investor has elected to retain.

50. Alternatively, the Investor may choose to cash settle the Call Option by paying the Cash Settlement Amount, thereby retaining ownership of the Approved Securities. No CGT event will arise in respect of the Approved Securities that have been retained by the Investor in these circumstances.

51. The Cash Settlement Amount is capital expenditure made to preserve the Investor's title to the Approved Securities. It will form part of the cost base and reduced cost base of the Approved Securities (subsections 110-25(6) and 110-55(6) of the ITAA 1997).

#### **Section 109-5: acquisition of CGT asset**

52. Section 109-5 of the ITAA 1997 applies to Investors to treat them as having acquired the Approved Securities at the time the Investors obtained beneficial ownership of the Approved Securities. This is the Drawdown Date, being the date at which UBS applies the Initial Advance to acquire the Investor's Approved Securities.

#### **Section 110-25: cost base of notional put option**

53. That part of the interest incurred on the Protected Loan which is reasonably attributable to the cost of capital protection (if any) will form part of the cost base and reduced cost base of the notional put option (subsections 110-25(2) and 110-55(2) of the ITAA 1997). Where the capital protection under the PGI is invoked, the notional put option is taken to have been exercised pursuant to subsection 247-30(1) of the ITAA 1997. Any capital gain or capital loss on exercise of the notional put option is disregarded (subsection 134-1(4) of the ITAA 1997). The second element of the Investor's cost base and the reduced cost base for the Approved Securities will include that part of the interest incurred on the Protected Loan which is reasonably attributable to the cost of capital protection, being the cost of the notional put option (subsection 134-1(1) of the ITAA 1997, item 2).

#### **Section 104-25: CGT event C2**

54. Where the capital protection under the PGI is not invoked, the notional put option will expire at maturity. The expiration of the notional put option gives rise to CGT event C2 (paragraph 104-25(1)(c) of the ITAA 1997). The capital proceeds on the lapsing of the notional put option will be nil. The Investor will make a capital loss equal to the reduced cost base of the notional put option.

#### **Section 115-5: discount capital gains**

55. Division 115 of the ITAA 1997 allows a taxpayer a discount on capital gains in certain circumstances. In accordance with

section 115-5 of the ITAA 1997, any capital gain made by an Investor on the sale of the Approved Securities received pursuant to repayment of the Protected Loan will be treated as a discount capital gain where the Investor is an individual or a trust has held its investments in the PGI for at least 12 months (excluding the days of acquisition and disposal).

### **Schedule 2C: commercial debt forgiveness**

56. Where the limited recourse feature of the Protected Loan comes into effect, the Investor is not required to pay the Protected Loan Balance, and therefore there will be commercial debt forgiveness under section 245-35 of Schedule 2C of the ITAA 1936. Under Schedule 2C where a forgiveness results in the Investor having a positive 'net forgiven amount', the Investor will be required to reduce certain tax attributes to the extent of the net forgiven amount.

57. To determine the net forgiven amount of a debt forgiveness it is first necessary to determine the 'gross forgiven amount'. In the Investor's circumstances Schedule 2C of the ITAA 1936 will have no practical effect as the gross forgiven amount in respect of the debt will be equal to zero. The gross forgiven amount is equal to the 'notional value' of the debt less any consideration paid or given in respect of the debt.

58. The notional value of the Protected Loan Balance is the *lesser* of the limited recourse debt outstanding at the time of the debt forgiveness and the market value of the lender's rights in relation to the Approved Securities at the time of the debt forgiveness, under section 245-60 of Schedule 2C of the ITAA 1936. The situation where the limited recourse feature of the Protected Loan may come into effect is where the market value of the Approved Securities will not cover the Protected Loan Balance. In such a situation the market value of UBS's rights in relation to the Approved Securities should be no more than the market value of the Approved Securities at that point in time.

59. The consideration paid by an Investor in respect of the debt forgiveness would be equal to the market value of any property given by the Investor, in respect of the debt forgiveness as determined at the time of the forgiveness, under paragraph 245-65(1)(b) of Schedule 2C of the ITAA 1936. This market value should be equal to the market value of UBS's rights in relation to the Approved Securities. Therefore the gross forgiven amount will be nil.

60. Accordingly, Schedule 2C of the ITAA 1936 will not reduce an Investor's tax attributes where the limited recourse feature of the Protected Loan comes into effect.

### **Part IVA**

61. Provided that the scheme ruled on is entered into and carried out as described (see the Scheme section of this Ruling), it is

accepted that the scheme is an ordinary commercial transaction and that Part IVA of the ITAA 1936 will not apply.

## Appendix 2 – Detailed contents list

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Not previously issued as a draft

### *Related Rulings/Determinations:*

TR 95/33

### *Subject references:*

- debt deductions
- financial products
- interest expenses
- prepaid expenses
- product rulings
- public rulings
- taxation administration
- tax avoidance

### *Legislative references:*

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- ITAA 1936 82KL
- ITAA 1936 82KL(2)(a)
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