
TAX AND SUPERANNUATION LAWS AMENDMENT (2015 MEASURES NO. 2)
BILL 2015: INSTALMENT WARRANTS

EXPLANATORY MEMORANDUM

Chapter 1

Income tax look-through treatment for instalment warrants and similar arrangements

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to ‘look through’ an instalment warrant and instalment receipt trust so that all income tax consequences associated with the underlying asset of the trust ‘flow through’ to the investor, and not the trustee.

1.2 All references are to the ITAA 1997, unless otherwise stated.

Context of amendments

What are instalment warrants and receipts?

1.3 Instalment warrants are financial products that entail borrowing to invest in an asset, such as a share. The asset is held on trust during the life of the loan to provide security for the lender. The investor is required to pay one or more instalments before taking legal ownership of the asset, although the economic benefits (such as dividends) still flow through to the investor during this time. It is common for the borrowing under these arrangements to be limited recourse in nature, meaning investors can ‘walk away’ from the investment at any time.

1.4 Instalment receipts are similar to instalment warrants, although the key difference is that there is no ‘borrowing’. Rather, there is a provision of credit.

What is the taxation treatment?

1.5 The long-standing industry practice for certain types of instalment warrants and receipts has been to ignore the trust and to treat the investor as the owner of the asset. On the basis of this long-standing practice, a significant market for instalment warrants and receipts has developed.

1.6 The types of arrangements within this market have evolved over time and become more complex. As a result, these amendments seek to remove any uncertainty about how the law applies and confirm the industry practice for the types of instalment warrant and receipt arrangements that existed at the time of the announcement. This will avoid any disruption to that significant market that developed on the basis of the long-standing industry practice.

Summary of new law

1.7 These amendments provide look-through income tax treatment for instalment warrants and instalment receipts to remove uncertainty about the taxation treatment of such arrangements and to prevent disruption of the significant market that existed for such arrangements at the time of announcement of this measure. In particular:

- look-through treatment is provided to investors for instalment warrants and instalment receipts for which a significant market existed at the time the measure was announced (broadly, direct and indirect interests in listed securities as well as unlisted securities in widely held entities); and
- superannuation funds are eligible for look-through treatment for any limited recourse borrowing arrangement that satisfies the requirements of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)*.

Comparison of key features of new law and current law

| <i>New law</i> | <i>Current law</i> |
|---|---|
| The investor of the instalment warrant or receipt is treated as the owner of the asset of the instalment warrant or receipt trust (with some exceptions), instead of the trustee. This means that the trust is ignored and anything that happens to or results from being the owner of the asset, such as receiving dividends and franking credits, affects the investor and not the trustee. | Some uncertainty has arisen around whether this trust relationship can be ignored for income tax purposes. However, the long-standing practice has been to ignore the existence of the instalment trust for income tax purposes (with some exceptions). |

Detailed explanation of new law

1.8 These amendments provide look-through income tax treatment for certain instalment warrants, certain instalment receipts and for limited recourse borrowing arrangements entered into by superannuation funds. *[Schedule #, item 1, sections 235-1 and 235-805]*

1.9 Look-through treatment for income tax purposes is achieved by:

- treating the investor, and not the trustee, as the owner of the assets of the instalment trust;
- treating any acts done by the trustee in relation to the assets of the instalment trust as if they had been done by the investor, instead of by the trustee; and
- treating the investor as having the asset in the same circumstances as the investor actually has the interest in the trust.

[Schedule #, item 1, sections 235-805 and 235-820]

What arrangements receive look-through treatment?

Instalment warrants

1.10 An instalment warrant is a derivative-based investment product that allows an investor to purchase an asset (such as a share or unit in a unit trust) by payment of instalments over the life of the warrant. The asset is held on trust as security for repayment of the loan, although the benefits of ownership (such as dividends and franking credits) flow through to the investor. After the final payment is made, the investor obtains legal ownership of the underlying asset. *[Schedule #, item 1, section 235-820]*

1.11 It is common for the borrowing under these arrangements to be limited recourse in nature, meaning investors can 'walk away' from the investment at any time. These amendments include this feature by only providing look-through treatment where the rights of the lender in cases of a default are limited to the underlying assets of the trust, and not to any of the investor's other assets. Consequently, arrangements which seek to be able to claim against the investor's other assets where the investor defaults would not be eligible for look-through tax treatment. *[Schedule #, item 1, paragraph 235-830(1)(c) and subsections 235-830(2) and (3)]*

1.12 The underlying investments must not be subject to any charge (including a mortgage, lien or other encumbrance) apart from this limited

recourse feature. This is to ensure that the rights of the lender in respect of the secured assets cannot be defeated by such a charge. *[Schedule #, item 1, subsection 235-830(3)]*

Types of instalment warrants

1.13 There are broadly three different situations in which an investor acquires an instalment warrant (described below). Providing the relevant conditions are satisfied in these amendments, look-through treatment is available under each arrangement.

- ‘Cash applicants’ pay an upfront amount for an instalment warrant over a ‘new’ asset — that is, where they have not previously owned the underlying asset or an instalment warrant over the underlying asset.
- ‘Share applicants’ effectively convert an asset they already own into an instalment warrant over that asset (which becomes the underlying asset). The applicant receives cash from the provider of the instalment warrant, reflecting the outstanding instalments the investor must pay to regain legal ownership of the asset (less fees and borrowing costs).
- ‘Roll-over applicants’ already hold an instalment warrant over the underlying asset, and instead of paying the outstanding instalment(s) at the maturity date, rolls over into another instalment warrant over the same asset. The investor may pay additional money or receive money back, in order to maintain an agreed leverage ratio.

[Schedule #, item 1, sections 235-820 and 235-830]

1.12 These amendments also cover secured financing arrangements that are structured in the same way as an instalment warrant but are not necessarily termed an instalment warrant, such as certain limited recourse loan facilities. Provided the criteria of an instalment warrant trust are satisfied, these amendments apply to these other secured financing arrangements to provide look-through treatment for the investor and to ignore the trust for income tax purposes (subject to the exceptions as discussed at paragraph 1.54). *[Schedule #, item 1, sections 235-820 and 235-830]*

Instalment receipts

1.14 Instalment receipts are similar to instalment warrants, although the key difference is that there is no ‘borrowing’. Rather, there is a provision of credit. *[Schedule #, item 1, section 235-835]*

What assets of the instalment warrant or receipt trust are covered by the look-through treatment?

1.15 At the time of the announcement of the measure, there was a significant market for instalment warrants and instalment receipts over listed securities (held directly or indirectly by the trustee) as well as unlisted securities in widely held entities. These amendments cover such assets, given the policy rationale is to reduce any uncertainty about how the current law applied to the significant established market of instalment warrants and receipts that existed at the time of the measure's announcement. *[Schedule #, item 1, section 235-825]*

Assets held directly by the instalment warrant or receipt trust

1.16 Specifically, the assets covered by these amendments are modelled on the Division 247 provisions (capital protected borrowing rules), which provide a description of the types of assets that existed at the time of announcement that are the subject of an instalment warrant or receipt. In the cases where the trustee owns shares, units in a unit trust or stapled securities directly, look-through treatment is provided so that the investor in the instalment warrant or receipt is treated as owning those assets. *[Schedule #, item 1, sections 235-820 and 235-825]*

1.17 This treatment is only provided where shares or units are in a company or unit trust that is listed (as defined in the ITAA 1997 dictionary) or is a widely held entity. Widely held takes the same meaning as used in Division 247, thus the 'widely held company' definition in the ITAA 1997 dictionary must be satisfied. For a unit trust, the widely held unit trust definition in section 272-105 in Schedule 2F to the *Income Tax Assessment Act 1936* (ITAA 1936) must be satisfied. *[Schedule #, item 1, paragraph 235-825(2)(b)]*

Assets held indirectly by the instalment warrant or receipt trust

1.18 In some cases, a trustee may hold the assets described above indirectly through another trust. Consistent with Division 247, these amendments ensure that where the trustee holds an interest in a trust (other than an interest in a unit trust) that is subject to the instalment warrant or receipt, the investor receives look-through treatment in respect of the instalment trust's interest in the interposed trust. Look-through treatment is only provided in these cases where the interposed trust holds shares, units or stapled securities that are all either listed or widely held. If the interposed trust holds assets outside of these categories (i.e. it holds assets other than shares, units or stapled securities), this does not impact on whether look-through treatment is provided where these other assets are not securing the investor's borrowing or provision of credit. *[Schedule #, item 1, subparagraph 235-825(2)(a)(ii) and paragraph 235-825(2)(b)]*

Example 1.1

Matt, an Australian resident investor, acquires an instalment warrant over an interest in a fixed trust (Clefton Trust). That is, Matt has an interest in an instalment warrant trust (Instalment Trust) and the trustee of Instalment Trust has an interest in Clefton Trust.

The trustee of Clefton Trust holds shares and units in a variety of listed and widely held companies and unit trusts. Therefore, as all of the shares and units that the trustee of Clefton Trust holds are widely held or listed, look-through treatment is provided in respect of Instalment Trust such that Matt is taken to own the interest in Clefton Trust.

Bundles and Baskets

1.19 An instalment warrant bundle is a commercial term to describe a trust holding multiple assets of the same type. For example, a trustee holds multiple XYZ shares. In comparison, an instalment warrant basket refers to a trust with different assets within the trust. For example, a trustee holds shares in ABC Limited, DEF Limited and XYZ Limited.

1.20 As there was a significant market for bundles and baskets at the time of the announcement of this measure, these amendments cover such arrangements where the basket or bundle of underlying investments would be eligible for look-through treatment. That is, look-through treatment is provided where the underlying investments are listed units or shares (held directly or indirectly by the trustee) or are unlisted but widely held.

[Schedule #, item 1, section 235-820 and 235-825]

Replacement assets

1.21 The trustee of the instalment trust may hold assets that are replaced during the life of the agreement, for example, due to a corporate restructure where a share in one company is replaced with a share in another company. Providing the replacement asset is a covered asset and the asset vests in the trustee to secure the borrowing (for a warrant) or the provision of credit (for a receipt), look-through treatment is provided. If look-through treatment is provided for both the original and replacement asset, as the investor would be taken to own both assets, a taxpayer may be eligible to access a capital gains tax (CGT) roll-over to defer any CGT liability arising from the change in assets (providing relevant roll-over conditions are satisfied). *[Schedule #, item 1, section 235-820 and 235-825]*

What if an asset that forms part of the trust is not a covered asset?

1.22 Where the asset is not a covered asset and that asset vests in the trustee to secure a borrowing or a provision of credit (i.e. it is part of the

underlying investment of the instalment warrant or receipt trust), then look-through treatment is not provided for any of the assets that make up the underlying investment of the trust. This may happen, for example, where the instalment warrant trust owns a closely held share or unit, or where the interposed trust holds a closely held share or unit. *[Schedule #, item 1, sections 235-825 and 235-830]*

Example 1.2

Following on from Example 1.1, if one of the shares or units in the Clefton Trust were in a non-listed or closely held company or unit trust, or if Clefton Trust was a closely held unit trust, such that the Instalment Trust's unit in Clefton Trust was not listed or widely held, look-through treatment would not be provided in respect of Instalment Trust. This would mean that the investor, Matt, would not be treated as owning the interest in the Clefton Trust.

1.23 However, if the trust contains assets that are not related to the instalment warrant or receipt (that is, the assets are not used to secure the borrowing or provision of credit), then these assets are not tested under these amendments and are therefore not eligible for look-through treatment. These assets are not tested as they do not secure the borrowing or the provision of credit. Because of this, these assets do not impact on whether the assets which secure the borrowing or provision of credit receive look-through treatment. *[Schedule #, item 1, paragraphs 235-825(2)(a), 235-830(1)(a), and 235-835(a)]*

Employee share schemes

1.24 Consistent with Division 247, no look-through treatment is provided for instalment warrant or receipt trusts where part of the underlying investment is an employee share scheme (ESS) interest, as defined in subsection 83A-10(1). Providing look-through treatment could extend the scope of the ESS provisions, as it would allow employers to satisfy the ESS requirements by offering instalment warrants. *[Schedule #, item 1, subsection 235-825(3)]*

Superannuation funds - Limited recourse borrowing arrangements

1.25 The *Superannuation Industry (Supervision) Act 1993* (the SIS Act) prohibits superannuation fund trustees from borrowing money, subject to limited exceptions, to minimise other assets of the fund being put at risk in the event of default on the loan.

1.26 One exception, contained in section 67A of that Act, permits superannuation fund trustees to borrow money on a limited recourse basis to acquire assets that the fund would otherwise be permitted to acquire directly.

1.27 In order to prevent superannuation funds from being disadvantaged compared with other entities outside the superannuation system, this measure provides look-through treatment for superannuation funds where the arrangement satisfies the requirements under section 67A. *[Schedule #, item 1, section 235-820 and subsection 235-840]*

1.28 The SIS Act requires superannuation funds to use a trust when using a limited recourse facility, which consequently may subject the superannuation fund to a CGT taxing point on payment of the final instalment. Such restrictions are not imposed on entities outside of superannuation. Therefore, by providing superannuation funds with look-through treatment for any limited recourse borrowing arrangement that satisfies subsection 67A(1) of the SIS Act, this disadvantage is removed. *[Schedule #, item 1, section 235-820 and subsection 235-840]*

Instalment receipts

1.29 In relation to instalment receipts, as these arrangements are not restricted by the requirements in section 67A of the SIS Act, they receive the same income tax treatment as non-superannuation fund investors. That is, the instalment receipt must be over a covered asset as described above. *[Schedule #, item 1, section 235-835]*

How is look-through treatment provided under the income tax provisions?

1.30 By treating the asset as being an asset of the investor and not an asset of the trust, the amendments ensure the investor stands in the shoes of the trustee for all purposes of the income tax law (apart from key exceptions discussed in paragraph 1.54). As emphasised by the object clause, this is a broad based principle providing flow-through treatment of the income tax consequences to the investor. The parenthesised words in the key operative look-through provision, namely “*instead of being an asset of the trust*”, make it clear that the trust is ignored for income tax purposes. This means that anything that happens to or results from being the owner of the asset, such as receiving dividends and franking credits, affects the investor and not the trustee. *[Schedule #, item 1, section 235-810 and subsections 235-815(2) and 235-820(1)]*

1.31 Additionally to complement this broad-based principle, any acts done to the asset by the trustee (such as selling the asset) are taken to have been done by the investor and not by the trustee. *[Schedule #, item 1, section 235-810 and subsection 235-820(2)]*

Trust is ignored for income tax purposes

1.32 To the extent that these amendments apply, the trust consequently does not exist for the income tax purposes (but for the

exceptions). This is because for a trust to exist, trust property must be held by the trustee. Where the assets are deemed to instead be held directly by the investor, no trust property exists and consequently no trust exists for income tax purposes. Naturally, this has no effect of the existence of the trust at law. Given the trust is taken not to exist for income tax purposes (apart from the key exceptions discussed in paragraph 1.54), it is not necessary to consider if any further income tax consequences might result for the trustee or beneficiary where the deeming operates, such as in relation to the beneficiary's interest in the trust. *[Schedule #, item 1, section 235-810 and subsections 235-815(1) and 235-820(1)]*

1.33 Importantly, however, these amendments do not operate for certain withholding tax purposes and the tax file number provisions (see paragraph 1.54). Accordingly, to the extent that these amendments do not operate, as a result of the trust not receiving look-through treatment on all of its assets or due to being specifically excluded (see paragraphs 1.22 to 1.23 and 1.54), the necessary income tax consequences result for the trustee and the beneficiary, as the trustee is not ignored for these cases under these amendments. *[Schedule #, item 1, subsections 235-820(1) and (2)]*

Determining the characteristics of the asset held by the investor

1.34 Where these amendments treat the investor as the owner of the trust assets, the investor is taken to hold those assets in the same circumstances as the investor holds the interest in the trust at law. This means that all of the characteristics of the investor, such as how the investor entered into the arrangement and with whom the investor holds the interest, are taken to exist in respect of the asset instead. The effect of this is that the assets adopt the same characteristics of the investor's actual interest in the trust, such as whether the asset is held on revenue or capital account or held as joint tenants or tenants in common. *[Schedule #, item 1, subsections 235-820(3) and (4)]*

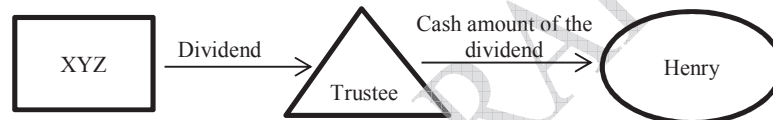
What are the income tax consequences of providing look-through income tax treatment?

Dividends

1.35 Where an investor holds an instalment warrant or receipt over a share, any dividends paid on that share will be paid by the company to the trustee. As a result of the investor being treated as the owner of the share, the investor stands in the shoes of the trustee and the trust is ignored. The effect of this is that the dividend is taken to be received by the investor and not by the trustee for income tax purposes. This enables the dividend assessing provisions to be satisfied in respect of the investor and not the trustee. *[Schedule #, item 1, subsection 235-820(1)]*

Example 1.3

Henry, an Australian resident investor, acquires an instalment warrant over XYZ share. Under the terms of the instalment warrant, Henry is entitled to the cash amount of the dividends payable on the XYZ share on the record date. As the trustee is the legal shareholder of the XYZ share, it is the trustee that receives the dividend. The terms of the instalment warrant require the trustee to pay the cash amount of the dividends it receives on the XYZ share to Henry as soon as practical after receipt and clearance of those dividends. Any dividend received by the trustee and not immediately paid on to Henry is held on trust for Henry. The flow of the dividend can be represented diagrammatically as follows.



As Henry is deemed to be the owner of the XYZ share, and the trustee is not, Henry is taken to stand in the shoes of the trustee. These amendments mean that Henry receives the dividend, as the owner, directly.

As the trustee is treated as not being the owner of the XYZ share, it is not capable of being the shareholder. Rather, Henry, as the owner of the XYZ share standing in the shoes of the trustee, is considered to be the shareholder for the purposes of the dividend assessing provisions, including the definition of 'dividend'.

In addition, by deeming Henry to be the owner of the XYZ share and the trustee not to be the owner, the payment of the cash amount of the dividend from the trustee to Henry is ignored.

As a result, Henry includes the dividends paid on the XYZ share in his assessable income under subparagraph 44(1)(a)(i) of the ITAA 1936.

Franking credits

1.36 Similar to the receipt of dividends, franking credits are also taken to flow directly to the investor as a result of the trust relationship being ignored. Where the dividends are franked dividends, then the effect of these amendments is that the investor is taken to have received the franking credits directly (instead of indirectly through the trust). This means that in determining the investor's income tax consequences of receiving the franking credits, the investor applies section 207-20 (the general gross-up and offset rule) instead of section 207-35, which applies

for distributions made through trusts. In addition, in determining whether the investor is entitled to the franking credit, the qualified person rules in former Division 1A of Part IIIAA of the ITAA 1936 are applied to the investor directly instead of those rules relevant for trustees and beneficiaries. *[Schedule #, item 1, subsection 235-820(1)]*

Capital gains tax

1.37 These amendments result in CGT consequences, including the following:

- no CGT event happens on payment of the final instalment;
- the investor's cost base (and reduced cost base) of the asset includes the upfront instalment paid by the investor and the liability assumed by the investor under the arrangement;
- where the asset is sold by the trustee, CGT event A1 happens for the investor instead of the trustee;
- for a cash applicant - the investor's cost base of the asset generally includes the instalment paid by the investor (less any amounts that are deductible) on actual acquisition of the asset by the trustee and any liability assumed by the investor;
- for a share applicant – the investor's cost base of the asset includes the value of the property provided by investor to acquire the asset;
- the investor's cost base will also include any amount paid for the granting of a put option by the lender (being the capital protection component) if the put option is exercised;
- for the purpose of applying the CGT discount on selling the asset, the investor is taken to have acquired the asset when the interest in the instalment warrant or receipt trust was acquired;
- no CGT taxing point would arise for a 'share applicant' transferring an asset into an instalment warrant trust. This is because the investor is treated as continuing to own the asset — effectively there is no disposal; and
- no CGT taxing point would arise for a 'roll-over applicant' who rolls over an instalment warrant into a new warrant over the same asset. This is because the underlying asset is still treated as being owned by the investor.

These CGT consequences are described in more detail below.

[Schedule #, item 1, subsections 235-820(1) and (2)]

No CGT event on absolute entitlement

1.38 Absent these amendments, where the investor is not absolutely entitled to the trust assets, then on payment of the final instalment the investor may become absolutely entitled to the trust assets as against the trustee. As a result, CGT event E5 could happen for the trustee on payment of that final instalment. The trustee would consequently make a capital gain or realise a capital loss if the market value of that asset had increased or decreased since the time of acquisition by the trustee. CGT consequences may also apply to the beneficiary's interest in the trust.

1.39 By treating the investor as the owner of the asset from the time that the investor acquires the interest in the trust, these amendments make it clear that no CGT event, and therefore no CGT taxing point, happens on payment of that final instalment for the trustee or the beneficiary.

[Schedule #, item 1, subsection 235-820(1)]

Calculating the investor's cost base of the asset where all instalments are paid

1.40 For the purposes of calculating the investor's cost base (and reduced cost base) of the asset of an instalment receipt trust, as the investor is taken to own the asset from the time of acquiring the interest in the trust, the investor includes in its cost base the instalments paid or payable under the arrangement. Therefore, where an investor pays all instalment payments required under the arrangement, the investor's cost base will include those instalment amounts. However, the instalment payments required under the arrangement may include amounts for interest and borrowing costs. To the extent that these amounts are deductible, they are not included in the cost base of the asset, in accordance with the ordinary cost base rules. *[Schedule #, item 1, subsection 235-820(1) and section 235-835]*

Example 1.4

Jack, an Australian resident investor, acquires an instalment receipt over an ABC share on 1 July 2014. Under the terms of the instalment receipt arrangement, Jack is required to pay \$4.00 (plus interest and transaction costs) upfront and \$6.00 on 1 July 2015. The ABC share is held by the trustee of the instalment receipt trust to secure the provision of credit of \$6.00. After payment of the \$6.00, Jack receives legal ownership of the ABC share. No CGT event happens on transfer of the legal ownership from the trustee to Jack as he is taken to have been the owner from the time of

acquiring his interest in the instalment receipt trust and therefore there is no change of ownership. Jack's cost base of the ABC share is \$10.00. The interest, subject to Division 247, and the transaction costs are deductible.

1.41 For the purposes of calculating the investor's cost base (and reduced cost base) of the asset of an instalment warrant trust, as the investor is taken to own the asset from the time of acquiring the interest in the trust, the investor includes in its cost base the upfront instalment paid and the liability assumed under the borrowing. The upfront instalment payment required under the arrangement may include amounts for interest and borrowing costs. To the extent that these amounts are deductible, they are not included in the cost base of the asset, in accordance with the ordinary cost base rules. *[Schedule #, item 1, subsection 235-820(1) and section 235-830]*

Put Option

1.42 Where the investor pays all instalments under the arrangement and obtains the legal title of the asset, the put option expires without being exercised. As the put option expires unexercised, the investor realises a capital loss on the expiry of the put option.

Calculating the investor's cost base (or reduced cost base) of the asset where some instalments are not paid

1.43 Where the investor does not pay an instalment payable under the instalment warrant arrangement, the trustee is typically empowered, on instruction by the lender, to sell the asset. The proceeds received from the sale of the asset are applied against any outstanding interest and costs due and the outstanding loan amount. Where the sale proceeds exceed these amounts, the excess is paid to the investor. As a result of these amendments, the investor, instead of the trustee, is taken to have sold the asset. This means that CGT event A1 happens for the investor and not the trustee. *[Schedule #, item 1, subsections 235-820(1) and (2)]*

1.44 As the investor is treated as the owner of the asset, it is also taken to have acquired the asset for the purposes of the cost base rules. Therefore the investor's cost base includes:

- the upfront instalment amount paid by the investor; and
- due to the assumption of liability rule in section 112-25 – the amount of the liability assumed by the investor to acquire the asset.

If the investor's liability under the loan is limited to the amount that the lender can sell the asset for, the amount included in the cost base as a result of the assumption of liability rule is also limited to that amount. *[Schedule #, item 1, subsections 235-820(1)]*

1.45 Where the investor has capital protection, the investor may choose to exercise the put option granted by the lender. Typically, the put option entitles the investor to require the lender to purchase the asset at maturity for the outstanding loan amount. As a result of these amendments the investor, instead of the trustee, is taken to have sold the asset to the lender in this case and therefore, CGT event A1 happens for the investor and not the trustee. *[Schedule #, item 1, subsection 235-820(2)]*

1.46 In determining any capital gain or capital loss the investor makes on the sale of the asset, the investor's capital proceeds are the outstanding loan amount. The investor's cost base includes the upfront instalment paid, the outstanding loan amount and the amount paid for the put option. *[Schedule #, item 1, subsection 235-820(1)]*

Example 1.5

Liam, an Australian resident investor, acquires instalment warrants over KZM shares on 1 July 2014. Under the terms of the instalment warrant arrangement, Liam is required to pay the following instalments for each instalment warrant:

- \$6.35 per instalment warrant upfront; and
- \$6.00 on 1 July 2015.

The upfront payment includes a principal amount of \$4.00, an upfront capital protection fee of \$1.20, a prepaid interest component of \$0.85, borrowing costs of \$0.10 and brokerage of \$0.20 per instalment warrant. Liam borrows \$6.00 from the lender which is used, together with Liam's upfront payment to acquire each KZM share. Each KZM share is held by the trustee of an instalment warrant trust to secure repayment of the outstanding loan amount.

Under the arrangement, Liam is granted a put option (for which he paid the capital protection fee) that entitles him to require the lender to purchase each KZM share on maturity for the outstanding loan balance. On maturity, the market value of a KZM share is \$5.00. Liam therefore chooses not to pay the final instalment of \$6.00. As the value of the KZM share is less than Liam's outstanding loan balance, the put option is exercised.

These amendments result in the KZM share being taken to have disposed of by Liam, instead of the trustee. Consequently, CGT event A1 happens for Liam on this disposal. Liam's capital loss from this CGT event is calculated as follows:

| | |
|---|---------|
| Reduced cost base (being the principal amount of the instalment payment, the liability assumed and the capital protection fee): | \$11.20 |
| Capital proceeds on disposal (being equal to the outstanding loan amount): | \$6.00 |
| Capital loss: | \$5.20 |

In addition, Liam can deduct the prepaid interest (subject to the application of Division 247), the borrowing costs and the brokerage fees.

Interest

1.47 Interest paid by the investor is generally deductible under the general deduction provision. This is subject to:

- the prepaid expenditure rules;
- the capital protected borrowing rules; and
- for share applicants – the loan funds being used to produce assessable income.

1.48 Typically, investors prepay interest under these arrangements. The deductibility of this interest is therefore subject to the application of the prepayment rules in sections 82KZM to 82KZMF of the ITAA 1936. In particular, as the investor is taken to own the asset instead of the trustee, the exception in subsection 82KZME(5) to the requirement to apportion the interest expenditure for certain taxpayers can be satisfied. That subsection prevents the proportional deduction rule in section 82KZMF from applying where the relevant taxpayer has borrowed money to acquire negatively geared real estate, shares or units in a unit trust which are expected to be income producing. *[Schedule #, item 1, subsection 235-820(1)]*

1.49 These amendments ensure that the investor owns the asset instead of the trustee and therefore the requirement to acquire negatively geared assets can be satisfied to preclude section 82KZMF from apportioning the deductibility of the interest expenses over different income years. *[Schedule #, item 1, subsection 235-820(1)]*

Income tax return

1.50 Section 161 of the ITAA 1936 provides that every person identified by the Commissioner must prepare an income tax return. The Commissioner publishes a yearly notice that sets out these requirements (see, for example, Legislative Instrument F2014L00688, in relation to the 2013-14 income year). In relation to a trust, the practice has been to require a tax return where the trustee of a trust estate has derived income (including capital gains). However, as these provisions ignore the trust where the underlying investments by the trust are in covered assets (as described above), no income tax return is required to be prepared by the trustee in these circumstances. Any income tax consequences in respect of the assets would be recognised in the investor's tax return. *[Schedule #, item 1, subsection 235-820(1)]*

1.51 In cases where the trust is not ignored as the trustee has invested in non-covered assets (see paragraphs 1.22 to 1.23), an income tax return is required to be lodged. That is, a return would be required to be lodged where the trustee of the trust estate has derived income (including capital gains). *[Schedule #, item 1, subsection 235-820(1)]*

Interactions with other income tax provisions

1.52 It is not necessary to consider whether the underlying investments of the instalment trust would satisfy the CGT look-through provisions, namely whether a security arrangement exists (section 106-60) or whether there is absolute entitlement (section 106-50). It is unnecessary to consider whether such provisions apply, as these amendments look-through for the entire income tax acts (with certain exceptions). That is, they provide a more expansive look-through treatment than the security holding and absolute entitlement provisions, which only apply for CGT purposes. *[Schedule #, item 1, subsections 235-845(1) and (2)]*

1.53 Additionally, Division 247, which isolates the cost of capital protection provided under a capital protected borrowing where it is not explicitly provided by way of a put option, continues to apply to arrangements (where relevant) that are subject to these amendments. *[Schedule #, item 1, subsection 235-845(3)]*

What income tax provisions do not receive look-through treatment?

1.54 While these amendments provide look-through treatment for the income tax provisions, certain exceptions apply to ensure the income tax law operates appropriately. These exceptions are consistent with the industry practice that has developed. Specifically:

- Part VA of the ITAA 1936, which contains the tax file number (TFN) provisions. Precluding these amendments from applying ensures that TFNs can be requested without breaching the TFN offence provisions in Subdivision BA of Part III of the *Taxation Administration Act 1953* (TAA 1953).
- Subdivision 12-E of Schedule 1 to the TAA 1953, which deals with withholding amounts where an entity invests and has not supplied a TFN or Australian Business Number (ABN). The trust is required to be recognised as it is that entity that is legally investing in the investment body, rather than the investor.
- Subdivision 12-F in Schedule 1 to the TAA 1953, which deals with withholding tax for dividends, interest and royalty payments made to foreign residents. Recognising the trust ensures that the trustee has the obligation to withhold tax as required.
- Subdivision 12-H in Schedule 1 to the TAA 1953, which contains the managed investment trust withholding provisions. Recognising the trust ensures that the trustee has the obligation to withhold tax as required.

[Schedule #, item 1, paragraphs 235-815(2)(a) and (b)]

Consequential amendments

1.55 Consequential amendments are made to the ITAA 1997 dictionary, namely inserting the definitions of ‘instalment trust’ and ‘instalment trust asset’. *[Schedule #, item 2, subsection 995-1(1) (definition of ‘instalment trust’ and ‘instalment trust asset’)].*

Application and transitional provisions

1.56 These amendments apply to assets that vest in the trust in the 2007-08 and later income years. These changes, which are beneficial to taxpayers and confirm the industry practice, are retrospective to broadly align with the application date of the provisions which allow superannuation funds to enter into limited recourse borrowing arrangements). *[Schedule #, item 3, section 235-810 of the Income Tax (Transitional Provisions) Act 1997]*

1.57 Applying these amendments from this time removes any uncertainty about how the law applies and ensures that the industry practice of ignoring the instalment warrant and receipt trust can continue to apply.

Amendment of assessments

1.58 The operation of section 170 of the ITAA 1936 (which provides time limits for amending assessments) is modified where an assessment has been made prior to the commencement of these amendments. In these circumstances, these amendments provide that taxpayers are able to seek an amended assessment within two years of these amendments commencing. This ensures that taxpayers are still able to receive the benefit of these changes despite the delay between the application date and passage of these amendments. *[Schedule #, clause 4]*

Transitional provisions for superannuation funds

1.59 Subsection 67(4A) was inserted into the SIS Act allowing funds to invest in certain types of limited recourse borrowings, with effect on and from 24 September 2007 (see *Tax Laws Amendment (2007 Measures No. 4) Act 2007*). The types of limited recourse arrangements covered by the SIS Act were modified in 2010, with a new subsection 67A(1) being introduced, taking effect for arrangements on and after 7 July 2010 (see *Superannuation Industry (Supervision) Amendment Act 2010*). Therefore, as the amendments apply from the 2007-08 income year, transitional rules ensure that superannuation funds that satisfied the (now repealed) subsection 67(4A) are able to access these look-through provisions in respect of pre-7 July 2010 arrangements. *[Schedule #, item 3, section 235-840 of the Income Tax (Transitional Provisions) Act 1997]*