

Submission in respect to the Exposure Draft of “Tax and Superannuation Laws Amendment (2015 Measures No. 2) Bill 2015: Instalment warrants” and its Explanatory Memorandum (Draft)

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This submission contains our preliminary analysis on two issues relating to the proposed changes to provide a “look-through” treatment for instalment warrants and instalment receipts. Due to the time constraint for the submission we may need to amend or supplement this submission at a later time.

Issue 1 to be addressed:

Interaction between the proposed “look-through” treatment for instalment warrants and instalment receipts and the provisions relating to segregated current pension assets

Analysis:

Significance of the issue

There is no discussion in the current Draft Explanatory Memorandum (“the draft EM”) direct relating to the interaction between the proposed “look-through” treatment for instalment warrants/receipts and the provisions relating to segregated current pension assets.

However, given that the proposed law directly impacts on a large number of complying superannuation funds utilising limited recourse borrowing arrangements and also superannuation funds holding instalment warrants/receipts, it is worth consider the interactions of the proposed law with the current tax law provisions relating to segregated current pension assets.

The proposed law’s effect on the concept of assets at general law

The proposed law appears to proceed on the basis that instalment trust assets (as defined) are “deemed” to be the assets held by the investors for income tax purposes (other than some specific exceptions).

The draft EM observes that where this “deeming” rule applies, the affected trust does not exist for the income tax purposes (but for the exceptions).

However, the draft EM also recognises that, the relevant trust still exists at law and by implication the interest in the affected trusts is still the asset actually owned by the investor at general law.

Indeed, the proposed s235-820(3) is an attempt to attribute the circumstances under which an investor holds the interest in an instalment trust to the underlying instalment trust assets deemed to be held by the investor.

Current provisions for segregated current pension assets

In general terms, income derived from segregated current pension assets is exempt income (s295-385 of Income Tax Assessment Act 1997 or ITAA 1997 in short). The capital gains (and losses) arising from CGT events happening in relation to segregated current pension assets are disregarded (s118-320 of ITAA 1997).

Segregated current pension assets are defined in s295-385 of ITAA 1997. Broadly speaking, these are the assets that are invested, held in reserve or otherwise dealt with solely to meet current pension liabilities. An asset for this purpose is not defined in the tax legislation and therefore takes its ordinary meaning. Obviously an asset for this purpose can include an interest in an instalment trust.

Difficulty arising from the proposed deeming rule

Following the deeming ruling to be introduced by the proposed legislation, a question will arise as to what “asset” needs to be set aside by a trustee of a superannuation fund as a segregated current pension asset in the instance involving an interest in an instalment trust: namely, is it the asset at general law being the interest in the instalment trust owned by the trustee; or the instalment trust asset that is deemed to be owned by the trustee for most income tax purpose?

On one view, the asset that is capable to support current pension liabilities should be the assets that the trustee legally owns at general law and hence should be the interest in the instalment trust, despite the ignorance of the trust for most income tax purposes. Where the trustee segregates this interest in the instalment trust the underlying instalment trust asset(s) should take the same characteristic pursuant to the proposed s235-820(3) and be treated as “segregated current pension asset(s)”, subject to other conditions governing the segregated current pension asset definition being met. Should this approach be considered as appropriate it is highly desirable that a revised EM will confirm it and perhaps a suitably worded example or a note is also used in the proposed legislation.

However, such an approach may not be entirely satisfactory due to a potential for double counting. This is because under the deeming operation the instalment trust assets taken to be held by the trustee for the superannuation fund. Thus it raises a question as to how to value these assets for the purposes of s294-385(3) and also for the purposes of s294-385(6).

Alternatively, a view may be taken for a trustee of a superannuation fund to ignore the interest in an instalment trust as an asset and to allocate the instalment trust assets deemed to be held by the trustee for the purpose of segregated current pension assets. It would be helpful if a revised EM can

confirm it (e.g. by making it clear that the term “asset” in this case does not take its ordinary meaning and is affected by the deeming rule). And further consideration should be given to ensure any consequential requirements (such as an actuary’s certificate) are directed toward the deemed assets a trustee has set aside, instead of the assets owned by the trustee at general law.

This alternative approach is not without its own difficulties. For example, there is a question mark as to whether this is consistent to s235-820(3). Secondly, for an asset that is deemed to be held by the trustee, how to determine the trustee is holding them for the required purposes (namely to meet current pension liabilities) may require further thinking and clarification.

Practices to be protected

In practice, the abovementioned two approaches may have been adopted by various superannuation funds, depending on their understanding of the tax law, both prior to and post the announcement of the proposed changes.

It is submitted that no matter what particular approaches a complying superannuation fund has adopted thus far, appropriate provisions should be enacted to afford them the legal protection in respect to the income derived from the segregated current pension assets can retain the exempt income status.

Conclusion:

It is submitted that more considerations should be given to directly address the issue identified, to confirm the most appropriate view and to afford suitable protection to whatever practice adopted to date.

Other observation:

It is observed that a similar issue may also exist in terms of segregated exempt assets of life insurance companies.

Issue 2 to be considered:

Consequences of CGT events happening to an interest in an instalment trust

Analysis:

A brief outline of the proposal (is so far as it is relating to the identified issue)

The proposed law appears to be silent as to what may be taken to happen to the underlying instalment trust asset if a CGT event happens to an interest in an instalment trust. Also, it does not express a straight forward view to the readers of the legislation of the direct CGT consequence to the an interest in an instalment trust which would otherwise a CGT asset but for the deeming rules.

In paragraph 1.32 of the draft EM, it is claimed that “To the extent that these amendments apply, the trust consequently does not exist for the income tax purposes (but for the exceptions).” It goes

on to say: “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.”

It follows that an interest in an instalment trust should be discarded for CGT purposes (as the CGT provisions are not amongst the exceptions to the deeming rules).

Concerns about the current form of the proposed law and desirable improvements

However, because the trust is nevertheless recognised in general law, under the current definition of a CGT asset, it may not be apparent to a reader of the legislation that the proposed deeming rules will cause an interest in an instalment trust be completely ignored for CGT purpose.

It may be of benefit, even simply for the avoidance of doubt, to declare in the legislation itself that an instalment trust is completely ignored for income tax purposes including CGT provisions (other than for the specific exceptions). In addition, suitable note(s) are to be inserted to remind the reader that an interest in an instalment trust is taken not to be a CGT asset.

On the other hand, various CGT events happens to the interest in an instalment trust can have impact on the investor that is reflected on the investor’s deemed holding of the related instalment trust asset.

Thus, when a disposal of an interest in an instalment trust occurs, the deemed holding of the related instalment trust asset changes accordingly and it may be appropriate to spell out the effect.

It is submitted that considerations should be given on the impacts of other types of CGT events to see whether it is appropriate to outline the general impacts. It may be that most (if not all) CGT events happening to an interest in an instalment trust can be attributed to the related instalment trust asset. A clear outline of these impact would be of great benefit to the readers of the new legislation.

Conclusion:

It is highly desirable that the proposed legislation itself can clarify the effect of the look through deeming rule on the CGT status of an interest in an instalment trust and the impacts of the various CGT events happening to such an interest.