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THE MARK OF EXPERTISE

16 February 2015

Ms Tania Koit
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52 Goulburn Street
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By email: instalmentwarrants@treasury.gov.au

Dear Ms Koit,

Look-through treatment for instalment warrants and instalment receipts

The Tax Institute welcomes the opportunity to make a submission to Treasury in relation to the *Tax and Superannuation Laws Amendment (2015 Measures No. 2) Bill 2015: Instalment warrants* exposure draft legislation (**Exposure Draft**). We congratulate the Government for proceeding with this long-awaited legislative clarification.

We support the Government's stated policy intention behind this measure, namely to:

> "*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*".[1]

We offer the following comments to ensure that the Exposure Draft gives effect to its policy. In summary, the Exposure Draft should be amended to:

- Broaden the underlying assets covered;
- Include a saving rule for matters outside the investor's control;
- Remove the limited recourse requirement or amend this requirement;
- Allow charges over underlying assets;
- Clarify that it is the immediate owner who is deemed to own the asset;
- Clarify that other look-through provisions continue to apply if you fall outside these amendments;
- Clarify that other look-through provisions do not apply if you fall inside these amendments;
- Ensure that the qualified person rules will operate as intended; and

[1] Explanatory Memorandum to the Exposure Draft at paragraph 1.7.

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- In relation to Limited Recourse Borrowing Arrangements, use consistent terminology and ensure that the amendments apply after any borrowing is repaid.

Instalment warrants and receipts

Broaden the assets covered

The assets covered by the Exposure Draft per section 235-825 are restrictive. The list of instalment trust assets should be widened to include the following:

a) assets that arise or become instalment trust assets in connection with a corporate action affecting the existing instalment trust assets, such as rights issues, takeovers and in specie distributions;
b) assets that arise or become instalment trust assets as an ordinary incident of the holding of the existing instalment trust assets;
c) rights to receive delivery of shares/units/stapled securities under a securities lending arrangement;
d) depositary receipts;
e) cash securities; and
f) shares/units/stapled securities that are neither listed nor widely held.

Corporate actions relating to the instalment trust assets can in many cases be expected to result in the security trustee holding other kinds of assets not covered by the current drafting. More commonly, this might include non-listed, non-widely held equities (in the event of certain takeovers) or options or warrants (rights issuances). However, the universe of corporate actions is infinite, and there is no limit on the type of assets that may result, e.g. through in specie distributions or through schemes of arrangement. It is therefore submitted that corporate actions be covered in concept, rather than by stipulating certain types of assets.

In the ordinary course, the trustee may come to hold other assets, such as cash (dividends that are not stipulated to be distributed or applied against the loan), or contractual or litigation rights (e.g. rights against the issuer of a security), which arise merely incidentally in the course of holding the instalment trust assets. Again, it is difficult to comprehensively describe these situations, and it is submitted that a category should be inserted to deal with these incidental situations in circumstances where there has been no change to the instalment trust arrangement itself.

Many instalment warrant products on issue at the time of the announcement permitted stock lending by the security trustee. The trustee's right to redelivery of the securities would not satisfy the share/unit/stapled security limitation. It is submitted that a specific category should be included.

Depending on the particular arrangement in question, depositary receipts may or may not satisfy the current share/unit/stapled security limitation. It is submitted that a specific category should be included.

Whilst not known to be a large part of the market in 2010, such assets are an obvious extension to the shares/units/stapled securities currently listed, and inclusion in instalment trusts would allow issuers to reduce some of the inherent risks associated with pure equity investments.

The limitation of shares/units/stapled securities to widely held or listed securities places a significant compliance burden on investors that they are not readily able to satisfy. It is submitted that the widely held/listed requirement be removed.

A saving rule for events outside investor's control

There may be numerous situations where the instalment trust assets limitations are breached through no fault of the investor or trustee, but rather due to circumstances outside their control. Furthermore, such circumstances may even be irreversible. It is submitted that where these limitations are breached due to circumstances outside of the investor or trustee's control, there is no reason why this should trigger a taxing point, or prevent look-through treatment from applying.

For example, if the above submission in relation to the broadening of the assets covered is not adopted, an investor would fall outside the provisions if the assets are no longer widely held, even though this is outside the investor's control.

Accordingly, a saving rule should be inserted whereby, if the instalment trust asset limitation is breached for reasons outside the control of the investor and the security trustee, the instalment trust will be deemed to continue to satisfy that requirement. Such provisions are not unusual, see for example the criterion in 275-30(b) of the Income Tax Assessment Act 1997 in relation to Managed Investment Trusts.

Remove or redraft limited recourse requirement

Instalment warrants are subject to limited recourse requirements in section 235-830 whereas instalment receipts are not: section 235-835. It is submitted that including this requirement for warrants would introduce a distortionary effect between two otherwise economically fungible arrangements, thereby artificially incentivising issuers to issue instalment receipts instead of instalment warrants.

It is also noted that instalment warrants are often drafted as full recourse borrowings supported by put options, rather than limited recourse arrangements.

If a limited recourse requirement is to be retained, the current concepts in Division 247 would be more appropriate. This would cover both limited recourse borrowings and full recourse borrowings with put options.

Allow charges over underlying investment

Section 235-830(3) prohibits the underlying investment in relation to instalment warrants covered by the Exposure Draft from being subject to any charge. This provision appears to replicate the limitation in section 67A(1)(f) of the *Superannuation*

Industry (Supervision) Act 1993 (the SIS Act). The rationale for this limitation in relation to superannuation funds is not an appropriate rationale for denial of look-through treatment.

There is a general prohibition on superannuation funds charging their assets.[2] An exemption to this prohibition is where the SIS Act or Superannuation Industry (Supervision) Regulations 1994 (the SIS Regulations) allows a charge over a superannuation fund asset (expressly or by implication).[3] Therefore, section 67A(1)(f) of the SIS Act was introduced to expressly allow a superannuation fund to charge a single acquirable asset under a limited recourse borrowing arrangement without breaching the SIS Regulations.

No such general prohibition exists for entities more broadly in income tax law. Accordingly the rationale for the limitation in section 67A(1)(f) of the SIS Act is specific to the superannuation context. Superannuation funds are covered by section 235-840 which incorporates the requirement in section 67A of the SIS Act, and therefore section 235-830(3) is not required for the purpose of dealing with this special requirement for superannuation funds.

The inclusion of this requirement could result in ordinary instalment trust arrangements ceasing to qualify for reasons outside the control of the trustee or investor. For example, underlying assets could become the subject of charges in the ordinary course of business, for example through trustee liens (imposed to satisfy the trustee's right of indemnity), company liens (e.g. in respect of partly paid shares), or statutory liens imposed by governmental authorities.

The immediate owner is deemed to hold the asset

Where there are multiple trusts involved, it is our understanding that the amendments are applied to deem the immediate owner to be the holder of the asset. For example, if the investor enters into the instalment warrant through a custodian, it is our reading of the amendments that the custodian would be regarded as the holder under these rules. The investor could then rely on other provisions of the income tax law to look through the custodian arrangement: see section 106-50 of the *Income Tax Assessment Act 1997*.

Other provisions continue to apply if these amendments do not apply

Section 233-815 sets out the application of the amendments. To avoid doubt, the explanatory memorandum should state that these amendments do not affect the availability of look-through treatment under other provisions in the income tax law.

Other provisions do not apply if these amendments apply

The interaction provisions that "switch off" section 106-50 and section 106-60 should also switch off other look-through provisions (such as the bare trust rule in the qualified

[2] Regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1994*.
[3] Regulation 13.15 of the *Superannuation Industry (Supervision) Regulations 1994*.

person rules, and the absolute entitlement rule in section 26BC). Consideration could be given to describing such other provisions in principal.

Section 235-845 indicates that certain sections of the income tax law that would otherwise have a look-through effect do not apply if these amendments apply. As a drafting matter, section 235-845 should either be comprehensive in listing all such sections, or should describe such sections in principle. Otherwise, the explicit inclusion of certain provisions may result in an implication that other look-through rules continue to apply.

Ensure that qualified person rules apply as intended

Section 235-820 sets out the look-through treatment. The Explanatory Memorandum indicates that this provision should be relied upon to apply the qualified person rules relevant to franking to the investor directly disregarding the trust: Explanatory Memorandum at paragraph 1.36. We note that the qualified person rules are in repealed legislation in Division 1A of Part IIIAA the *Income Tax Assessment Act 1936,* albeit incorporated by reference into the franking provisions in Subdivision 207-F of the *Income Tax Assessment Act 1997*. Section 235-820 and the Explanatory Memorandum indicate that the qualifying person rule in repealed section 160APHO (which deals with a person holding shares) should be applied rather than the other sections of that repealed Division relating specifically to trusts. We query whether the drafting of section 235-820 is sufficient to achieve this result or whether an express reference to section 160APHO should be made in that provision.

Limited Recourse Borrowing Arrangements (LRBAs)

Consistent terminology

Section 235-840(a) uses terminology “vests” which is inconsistent with the terminology used in the SIS Act. Ideally, consistent terminology should be used between the Acts unless there is a clear rationale for using different terms.

Treatment continues to apply after the borrowing is repaid

The amendments do not cover the tax implications once the LRBA loan has been repaid. Section 235-840(b) provides that the look through approach only applies to “an arrangement that is covered by the exception in subsection 67A(1) of the Act”. However, once the borrowing has been repaid there is no loan covered by section 67A(1) of the SIS Act, but the trust may still exist and hold the asset.

Self Managed Superannuation Funds (Limited Recourse Borrowing Arrangements – In-House Asset Exclusion) Determination 2014 extended the in-house asset exception for a LRBA to the period after the borrowing is repaid but the asset continues to be held in the holding trust. Paragraph 32 of the Explanatory Statement to that determination indicated that the extension was necessary because in practice the asset is unlikely to be transferred from the holding trust to the SMSF trustee when the borrowing under the LRBA is repaid.

Similarly, and for added clarity, the Exposure Draft (or at least the Explanatory Memorandum) should be amended to state expressly that the deemed look-through/direct holding tax treatment for an asset held by a holding trust under a LRBA that is covered by the exception in s section 67A(1) of the SIS Act continues to apply while the asset remains held in the holding trust after the borrowing is repaid.

That outcome is too subtle on the current drafting of the Exposure Draft which simply states the deeming applies if the asset vests in a trust for the benefit of the SMSF under a LRBA that is covered by the exception in section 67A(1) of the SIS Act. The implication of this wording is that the deeming continues for so long as the asset remains vested in that trust (i.e. without reference to when the borrowing is repaid). However, without the position stated expressly, there would remain uncertainty for example whether Division 43 capital works deductions may become lost in the holding trust after the borrowing is repaid.

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If you would like to discuss any of the above, please contact either me or Tax Counsel, Thilini Wickramasuriya, on 02 8223 0044.

Yours faithfully,

Stephen Healey
President