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The Treasury
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9 April, 2010

Instalmentwarrants_tax@treasury.gov.au

Re: Income Tax Treatment of Instalment Warrants Proposals Paper March 2010

Please find attached our comments on your Proposals Paper regarding the Tax Treatment of Instalment Warrants.

We support the general approach of the Proposals paper, but have raised issues of potential concern in relation to Related Party Guarantees and Related Party Financing of Instalment Warrants (arising from the concurrent Media Release from Minister Bowen).

Thank you for the opportunity to comment and should it be necessary to contact us on this issue in the future, please contact either myself or Michael Perry on (03) 8851 4555.

Yours sincerely,

Roger Timms
Head of Tax & Superannuation

**Submission by Taxpayers Australia Inc
(Incorporating Superannuation Australia Pty Ltd)**

In response to

Income Tax Treatment of Instalment Warrants Proposals Paper

9 April 2010

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Income Tax Treatment of Instalment Warrants

Background and Overview

The Proposals Paper indicates that the Tax Office has adopted a view that the current income tax law does not support the ‘accepted practice’ in respect of the taxation of traditional instalment warrants as the trustee of the instalment warrant trust owns the asset whilst the investor would typically be beneficially entitled to all of the income.

Notwithstanding this interpretation, the Tax Office has issued a number of product rulings in respect of traditional instalment warrants which effectively treat the investor as the owner of the underlying asset held on trust. This situation clearly requires clarification.

The Proposals Paper also indicates a Tax Office belief (without supporting evidence) that a number of irregularities have and continue to occur in relation to non-traditional instalment warrants in SMSFs.

On 10 March 2010, the Assistant Treasurer, Senator the Hon Nick Sherry, announced that the Government would introduce legislation to amend the income tax treatment of ‘traditional instalment warrants’. The Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, also announced that the Government would introduce legislation to amend the income tax treatment of limited recourse borrowings of complying superannuation funds to treat:

- the owner of an instalment warrant over an exchange traded security as the owner of the security; and
- a superannuation trustee who enters into a limited recourse borrowing arrangement for the purpose of purchasing an asset, as permitted under subsection 67(4A) of the *Superannuation Industry (Supervision) Act 1993* (the SIS Act), as the owner of the asset.

Further, the minister indicated that only licensed financial service providers would be able to offer instalment warrant arrangements to superannuation funds.

Comment on Proposals paper

The purpose of the Proposals Paper is to enable comment from interested parties on the policy design of the proposal and we welcome the opportunity to participate.

The comments which follow are in response to section four of the Proposals Paper – ‘Policy Design of the Proposal.’

4.1 Traditional Instalment Warrants

It is proposed that a ‘look-through’ approach be adopted which effectively ignores the instalment warrant trust for income tax purposes, provided the following characteristics are evident –

- i. A non-recourse borrowing by the investor and no other guarantee from the investor (or associates) to the lender. (A ‘non-recourse’ borrowing means that the lender has no recourse other than to the underlying asset.)
- ii. A trust exists, primarily to provide security for the outstanding loan (but only over the underlying asset).
- iii. The investor receives the benefits of ownership of the underlying asset, such as income derived from the asset (whether received at the time or directed on their behalf to reduce outstanding instalments) and capital growth.

The description of the characteristics of a traditional instalment warrant appears to indicate that there cannot, in any circumstances, be a guarantee provided in respect of the borrowing.

The Commissioner has to date apparently accepted the position that a third party guarantee – whether provided by a related party or not – would, of itself, be acceptable for the purposes of an instalment warrant arrangement, provided that no assets of the fund (other than the asset over which the non-recourse borrowing was held) were held at risk. In other words, such a guarantee could be provided in a capacity as a member of a SMSF against an asset that was outside the SMSF, but not in any capacity as a trustee of the SMSF over any assets within the SMSF.

If our reading of this aspect of the definition of a traditional instalment warrant is correct, we believe this proposal should be revised to accord with current practice.

We support a policy which results in the tax outcomes as described at item 4.1 of the Proposals Paper.

4.2 Non-recourse Borrowings of a Superannuation Trustee

We concur with the view that:

A superannuation trustee who enters into a non-recourse borrowing arrangement for the purpose of purchasing an asset, as permitted under subsection 67(4A) of the SIS Act, be treated as the owner of the asset for income tax purposes and will effectively ignore the trustee of the instalment warrant trust (or other borrowing arrangement) for income tax purposes.

The look-through approach is intended to achieve the following outcomes in respect of real property-

- The investor will be assessed on any income earned on the underlying asset, such as rental income.
- The investor (and not the trustee) will be able to claim any relevant deductions, such as capital allowance for the decline in value of property. Where relevant, the investor will also have to adjust the underlying asset's cost base.
 - However, such deductions may be taken away from the investor because of other parts of the income tax law.
- If the underlying asset is a depreciating asset, there will be no balancing adjustment when the trustee transfers it to the investor.

If the borrowing arrangement satisfies the requirements of the SIS Act, this rule will cover all underlying assets, including single exchange traded securities and real property.

There is an overlap between this rule and the rule described at section 4.1 above. A trustee of a superannuation fund that invests in a traditional instalment warrant over a single exchange traded security will be covered by both proposed rules.

This overlap is intentional and is consistent with the separate rationales behind each rule.

As indicated above, we support this outcome.

However, we also note that, whilst the Proposals Paper does not make reference to any aspects of the funding for instalment warrants, the concurrent media release by Minister Bowen stated that:

‘The amendments will extend the Government’s consumer protection framework to cover certain superannuation borrowing arrangements such as instalment warrants and thereby help protect the savings of fund members,’

‘The measure will ensure that only licensed financial services providers offer these arrangements to superannuation funds.’ and

‘To allow product providers time to adjust to the new arrangements, the Regulations would come into effect three months after being made.’

This raises the issue of self financing or related party financing of instalment warrants by superannuation funds, in particular SMSF’s. It is generally accepted that this form of financing is acceptable for instalment warrants however, if the comments of Minister Bowen are translated into legislation, that avenue will be removed for the majority of superannuation funds.

In our view, a statement confirming that the arrangements contemplated by the Proposals Paper may be carried by use of related party funding would be appropriate.

4.3 Links with Other Areas of the Tax Law

It is accepted that the operation of provisions such as Divisions 40 and 243 must be applied in the usual manner in order to determine the overall tax outcomes for a taxpayer who is deemed to be the owner of an asset in accordance with the proposed look-through provisions.