



Australian Government

Income Tax Treatment of Instalment Warrants

Proposals Paper

March 2010

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CONSULTATION PROCESS

Request for feedback and comments

We invite interested parties to lodge written submissions on the design of this proposal.

We also encourage the identification of any other issues, including interaction issues with other parts of the tax law that may be relevant to the design of this proposal. While submissions may be lodged electronically, by post or by facsimile, electronic lodgement is preferred.

Some specific questions to consider when preparing submissions include:

- How to define an instalment warrant trust as separate to other trusts?
- How does the 'look-through' treatment affect the obligations of the trustee (such as the need to file a tax return and the information the trustee must provide to the beneficiary)?
- Are there interaction issues with other areas of the tax law that are not addressed below?
- Are there transitional issues that need addressing?

Submissions will be made available on the Treasury website unless you clearly indicate that you would like all or part of your submission to remain confidential. Automatically generated confidentiality statements in emails do not suffice for this purpose. A request made under the *Freedom of Information Act 1982* for access to a submission marked confidential will be determined in accordance with that Act.

Closing date for submissions: Friday, 9 April 2010

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FOREWORD



I am pleased to release this discussion paper on proposals to address the income tax treatment of instalment warrants. Instalment warrants are a form of derivative or financial product that entails borrowing to invest in an asset such as a share or real property (the underlying asset). These changes seek to provide certainty to taxpayers. The changes also ensure that the opportunity for non-recourse borrowing by trustees of superannuation funds permitted under relevant regulation is not undermined by its tax treatment. This paper provides an opportunity for interested parties to express their opinions on the implementation of the proposal.

Consultation plays a valuable role in the development of policy responses to changes in the tax law and I look forward to receiving the views of the community on these important reforms.

A handwritten signature in black ink, appearing to read 'Nick Sherry'. The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Assistant Treasurer
Senator Nick Sherry

SUMMARY

On 10 March 2010, the Assistant Treasurer, Senator the Hon Nick Sherry, announced that the Government will 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, announced that the Government will introduce legislation to amend the income tax treatment of limited recourse borrowings of complying superannuation funds.

Specifically, the Government will legislate 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.

The media releases are available on the Assistant Treasurer's website and the Minister for Financial Services, Superannuation and Corporate Law's website.

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1. PURPOSE

This discussion paper forms the basis for consultation on this proposal and sets out, in broad terms, the way it may be implemented. The purpose of this discussion paper is to provide interested parties with an opportunity to comment on the policy design of the proposal.

2. WHAT ARE INSTALMENT WARRANTS?

Instalment warrants are a form of derivative or financial product that entails borrowing to invest in an asset, such as a share or real property (the underlying asset). In its simplest form, the investor makes an upfront payment, which typically includes prepaid interest and borrowing fees. The underlying asset is held on trust during the life of the loan to provide limited security for the lender. The investor is required to pay one or more future instalments.

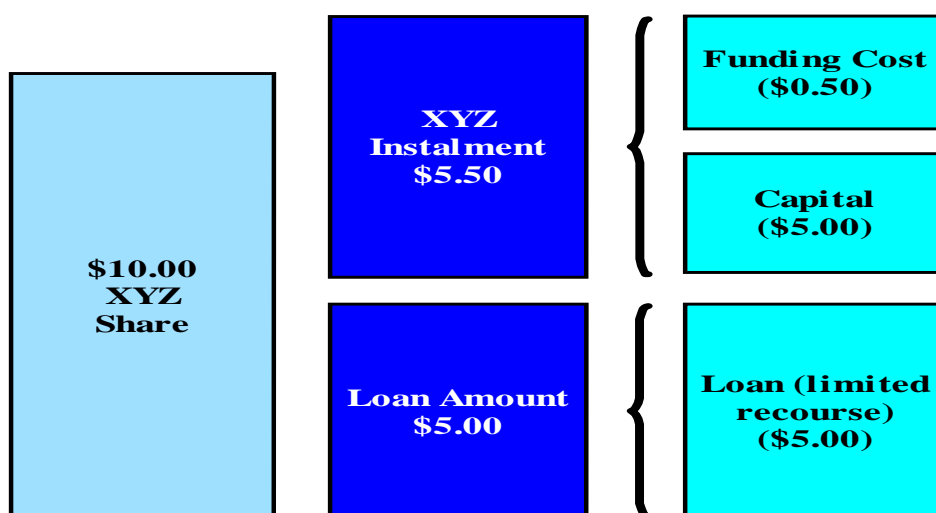
If the investor pays all the future instalments, the trustee transfers the underlying asset to the investor. Alternatively, the investor may direct the trustee to sell the underlying asset and transfer the proceeds to the investor (less any fees).

If the investor defaults on the outstanding instalments, the trustee sells the underlying asset to fund the outstanding instalments and any other costs.

- If excess funds remain after payment of these costs, the investor receives that excess.
- If the proceeds of the sale are less than the outstanding instalments and other costs, the lender has no ability to recover the shortfall from the investor. At worst, the investor can only lose their upfront payment and any paid instalments.

Figure 1 provides an example of an instalment warrant with one initial and one final instalment. The investor purchases the XYZ Instalment for \$5.50, which includes prepaid interest and any borrowing fees (the funding cost). The outstanding loan amount is \$5.

FIGURE 1 — BREAKDOWN OF AN INSTALMENT WARRANT



The above is an example of a ‘traditional instalment warrant’ — an instalment warrant over a single exchange traded security in a company, trust or stapled entity.

2.1 NON-TRADITIONAL INSTALMENT WARRANTS

Non-traditional instalment warrants include instalment warrants over real property. Instalment warrants over real property were most likely developed as a way for self managed superannuation funds (SMSFs) to borrow to invest in commercial and residential property without contravening the borrowing restrictions in the SIS Act. Other investors can borrow to invest in property directly without using a trust.

There does not seem to be a widespread market for instalment warrants over real property for investors other than superannuation funds.

2.2 DIFFERENT TYPES OF APPLICATIONS FOR INSTALMENT WARRANTS

There are broadly three different situations in which an investor acquires an instalment warrant.

- ‘Cash applicants’ pay an upfront amount for an instalment warrant over a ‘new’ asset — that is, they did not previously own the underlying asset or an instalment warrant over the underlying asset. Figure 1 is an example of a cash applicant.
- ‘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 expiry 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.

3. EXISTING LAW

The ATO advises that a technical interpretation of the current income tax law does not support the 'accepted' practice for the taxation of traditional instalment warrants. On a technical reading of the law, the trustee owns the underlying asset in the trust.

Any income derived by the trustee (together with any franking credits) is used to work out the net income of the instalment warrant trust. However, if the investor is entitled to all of the income of the trust, then they are assessed on the trust's net income. Also, the investor would be entitled to franking credits if the 'qualified person rules' are satisfied.

Recognising the trust also has specific implications for CGT. First, there is a CGT taxing point when the investor pays the final instalment (CGT event E5). This brings forward the CGT taxing point relative to the current practice, and the investor may have to sell the asset to meet any tax liability.

Second, the instalment warrant itself is a CGT asset as it is an interest in a trust:

- If the asset has increased in value, the investor may make a capital gain on the instalment warrant (separate to any capital gain made by the trustee). However, the anti-overlap rule may apply to prevent double taxation on gains made by the trustee.
- If the asset has fallen in value, the investor may make a capital loss on the instalment warrant. This allows the investor to claim a capital loss notwithstanding that the loss the trustee makes on the underlying asset is trapped in the trust.

3.1 'ACCEPTED' PRACTICE FOR TRADITIONAL INSTALMENT WARRANTS

The ATO has issued around 50 product rulings for traditional instalment warrants involving cash applicants. These product rulings effectively ignore the instalment warrant trust and treat the investor as the owner of the underlying asset that is held on trust.

- The investor is entitled to any distributions. As a matter of practice, investors have also received the associated franking credits relating to the underlying asset.
- If the investor pays the final instalment, the underlying asset passes from the trustee to the investor without a CGT taxing point. The investor's cost base for the underlying asset reflects the amounts paid to acquire the underlying asset (excluding fees), and not the market value when the investor becomes the legal owner of the underlying asset.
- If the investor defaults on any unpaid instalments, the trustee sells the underlying asset and the investor makes a capital gain or loss on that asset. For working out the investor's capital gain or capital loss, the cost base and reduced cost base of the

underlying asset is reduced by any unpaid instalments that are not recovered by the lender from the sale proceeds.

3.2 NON-TRADITIONAL INSTALMENT WARRANTS

In 2005, the ATO issued one product ruling for an instalment warrant over real property that applied broadly the same 'accepted' practice as for traditional instalment warrants. The ATO advises that this ruling does not constitute a part of the 'accepted' practice. Apparently, some SMSFs have invested in instalment warrants over property on this basis, including 'do-it-yourself' arrangements.

Anecdotal evidence suggests that the market for non-traditional instalment warrants is growing. The evidence also suggests that many of these arrangements (including do-it-yourself arrangements) have features that do not fit comfortably within the 'accepted' practice for the treatment of traditional instalment warrants. These features include financing arrangements that are not strictly loans, a more active role for the trustee in managing the asset, and little if any direct relationship between the trustee and the investor.

4. POLICY DESIGN OF THE PROPOSAL

This proposal consists of two elements. The proposed approach for each of these elements is discussed below.

Both elements are proposed to apply for assessments for the 2007-08 and later income years.

4.1 TRADITIONAL INSTALMENT WARRANTS

The owner of an instalment warrant over a single exchange traded security in a company, trust or stapled entity will be treated as the owner of the security for income tax purposes.

In other words, for traditional instalment warrants the proposal effectively ignores the instalment warrant trust for income tax purposes — a 'look-through' approach. This applies for all aspects of the income tax laws.

- The investor will be assessed on any distributions, and entitled to any associated franking credits.
- A 'cash applicant' will be treated as having acquired the underlying asset when they enter into the instalment warrant for the amount paid by the trustee to acquire it.
- There will be no CGT consequences for a 'share applicant' transferring an asset into an instalment warrant trust, provided the same effective ownership is maintained. This is because the investor is treated as continuing to own the asset — effectively there is no disposal.

- There will be no CGT consequences for a 'roll-over applicant' who rolls over an instalment warrant into a new warrant over the same asset. Any top up (refund) payment, such as to maintain an agreed leverage ratio, will be treated as a decrease (increase) in the loan amount.
 - This provides equivalent treatment to an investor who pays the final instalment and receives the asset, then enters into a new arrangement as a share applicant.
- There will be no CGT consequences for the trustee or investor when the investor pays the final instalment or if the trustee transfers the asset to the investor.
- An act done by the trustee of the instalment warrant trust in relation to the asset will be treated as if it had been done by the investor directly. For example, if the trustee sells the asset (such as at the direction of the investor or because the investor defaults), the investor will be treated as having sold the asset and be subject to CGT as appropriate.
 - However, the investor cannot make a capital loss larger than their actual investment (including capital protection costs but excluding interest payments).
- A disposal of (or other dealing with) the instalment warrant by the investor will be treated as a disposal of (or dealing with) the underlying asset. For example, the sale of an instalment warrant will be treated as the sale of the underlying security at the market price for that security. Any capital loss is restricted as above.

4.1.1 Characteristics of a traditional instalment warrant arrangement

An arrangement must have three key aspects in order to be an instalment warrant arrangement for the purposes of the proposed look-through approach:

- There is 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.)
- A trust exists, primarily to provide security for the outstanding loan (but only over the underlying asset).
- 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.

4.2 NON-RECOURSE BORROWINGS OF A SUPERANNUATION TRUSTEE

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, will be treated as the owner of the asset for income tax purposes.

As above, this proposal will effectively ignore the trustee of the instalment warrant trust (or other borrowing arrangement) for income tax purposes. The 'look-through' approach can have particular implications for 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 (see below).
- 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.

4.3 LINKS WITH OTHER AREAS OF THE INCOME TAX LAW

Although the investor in the instalment warrant will be treated as the 'owner' for income tax purposes, the investor will still be subject to other areas of the taxation law where another taxpayer may be treated as the economic owner or holder of the asset. Provisions that would have this effect include section 40-40 (depreciating assets) and Divisions 243 and 250 of the *Income Tax Assessment Act 1997*. Broadly, these provisions might act to deny or reduce capital allowance deductions for the investor where they are not the economic owner of the asset and/or do not bear the economic loss of the depreciation.

This will apply to instalment warrants and other non-recourse borrowings of superannuation trustees.

More generally, the Government will continue to monitor the use of these arrangements to ensure that the proposed tax treatment remains appropriate.