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Superannuation Update

The Instalment Warrant Revolution and its impact on superannuation

Introduction

There have always been various significant restrictions in relation to the investments that a superannuation fund may make.

Most of these restrictions are imposed by the *Superannuation Industry (Supervision) Act 1993* ("SIS Act"), and a breach of the SIS Act can lead to serious consequences. The restrictions may be regarded as the price to be paid for the significant tax advantages that superannuation funds offer.

One of the principal restrictions was that a trustee of a superannuation fund was prohibited from borrowing by section 67 of the SIS Act, which has been a significant impediment to the type of investments that a superannuation fund could make. However, recent changes to the SIS Act (effective from 24 September 2007) mean that trustees of superannuation funds may now borrow in prescribed circumstances, and may in fact pursue a geared investment strategy, provided that the requirements specified in the SIS Act are followed.

Prohibition against borrowing

To fully appreciate the impact of these recent changes, it is necessary to first understand the extent of the prohibition against borrowing by superannuation funds.

Subsection 67(1) of the SIS Act provides that a trustee of a regulated superannuation fund must not (a) borrow money; or (b) maintain an existing borrowing of money.

Subsections 67(2) to 67(6) contain exceptions from the prohibition in the following specific limited circumstances:

- payment of benefits – subsection 67(2);
- payment of contributions surcharge – subsection 67(2A);
- settlement of certain securities transactions – subsection 67(3);
- maintenance by a private sector fund of pre-12 June 1986 borrowings – subsection 67(5); and
- maintenance by a public sector fund of pre-2 July 1990 borrowings.

Before the amendments to the SIS Act that took effect on 24 September 2007, there were no other exceptions to the prohibition against borrowing, and it certainly was not possible for the trustee of a superannuation fund to pursue a geared investment strategy.

Subsection 67(7) provides that subsection 67(1) is a civil penalty provision, and the SIS Act therefore provides for civil and criminal consequences for contravening that subsection.

There is also a separate prohibition against charging set out in the *Superannuation Industry (Supervision) Regulations 1994* ("SIS Regs"). More particularly, regulation 13.14 of the SIS Regs provides that (subject to regulations 13.15 and 13.15A which are not relevant here), the trustee of a fund must not give a charge over, or in relation to, an asset of the fund. ("Charge" is defined in regulation 13.11 to include a mortgage, lien or other encumbrance.)

Instalment warrants

The recent amendments to the SIS Act have arisen because of problems associated with superannuation funds investing in financial instruments known as instalment warrants.

While the term "instalment warrant" has no technical definition, it has typically been understood to be a type of derivative financial instrument in relation to listed securities which has the following features:

- the warrant holder acquires beneficial ownership of a share via the payment of two or more instalments;

Inside

The Instalment Warrant Revolution and its impact on superannuation

Pg 1 – 3

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The Instalment Warrant Revolution and its impact on superannuation Continued

- pending payment of the final instalment the share is held on trust for the warrant holder, who benefits from any dividends paid on the share and growth in its capital value;
- the deferred instalments are effectively a loan by the warrant issuer (typically an investment bank) to the holder;
- if the warrant holder defaults on the loan, the issuer's recourse is limited to the share; and
- upon payment of the final instalment the warrant holder is entitled to receive a transfer of the share.

The effect of an instalment warrant for the holder is to provide geared exposure to the underlying asset.

One of the key features of instalment warrant arrangements was that the gearing was of a "limited recourse" nature. That is, while the investor effectively borrowed the deferred payment amount, if the investor failed to make the repayment there would be no liability beyond the value of the investor's equity in the underlying asset.

For these reasons, instalment warrants have long been promoted as an acceptable investment for superannuation funds seeking to leverage their exposure to the stockmarket.

The attitude of the regulators to instalment warrants

In December 2002, the Australian Taxation Office ("ATO") and the Australian Prudential Regulation Authority ("APRA") expressed the view that an investment in an instalment warrant by a superannuation fund may constitute a borrowing by the fund that would result in a breach of subsection 67(1). (Self managed superannuation funds are regulated by the ATO, and other funds are regulated by APRA.)

Guidelines were published in relation to what a trustee would need to consider in relation to such an investment.

In order to avoid disruption to financial markets, the Government announced on 3 November 2006 that it would "act to allow superannuation funds to continue to invest in instalment warrants, consistent with longstanding administrative practice."

Following industry consultation, the Government announced on 22 May 2007 that it would "legislate to allow superannuation funds to invest in instalment warrants of a limited recourse nature over any asset a fund would be permitted to invest in directly."

Instalment warrants had traditionally been understood to relate to listed securities only. The above announcement on 22 May 2007 therefore represented a significant departure from the announcement on 3 November 2006. However, having regard to the limited recourse nature of instalment warrants as stated above, the extension of the instalment warrant exception to all permissible asset classes is understandable in the context of subsection 67(1) as a risk management provision.

Legislative changes

The Government's policy was subsequently implemented by the *Tax Laws Amendment (2007 Measures No. 4) Act 2007* ("Amending Act") which received the Royal Assent on 24 September 2007.

The Amending Act amended section 67 of the SIS Act by inserting a new subsection 67(4A) to deal with instalment warrants. Subsection 67(4A) provides as follows:

"Exception – instalment warrants

(4A) Subsection (1) does not prohibit a trustee (the RSF trustee) of a regulated superannuation fund from borrowing money, or maintaining a borrowing of money, under an arrangement under which:

(a) the money is or has been applied for the acquisition of an asset (the original asset) other than one the RSF trustee is prohibited by this Act or any other law from acquiring; and

(b) the original asset, or another asset (the replacement) that:

(i) is an asset replacing the original asset or any other asset that met the conditions in this subparagraph and subparagraph (ii); and

(ii) is not an asset the RSF trustee is prohibited by this Act or any other law from acquiring;

is held on trust so that the RSF trustee acquires a beneficial interest in the original asset or the replacement; and

(c) the RSF trustee has a right to acquire legal ownership of the original asset or the replacement by making one or more payments after acquiring the beneficial interest; and

(d) the rights of the lender against the RSF trustee for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the original asset or the replacement; and

(e) if, under the arrangement, the RSF trustee has a right relating to the original asset or the replacement (other than a right described in paragraph (c))--the rights of the lender against the RSF trustee for the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the original asset or replacement."

The above new subsection 67(4A) does not define instalment warrants, but rather defines the features of a borrowing arrangement that qualifies for the exemption. In fact, subsection 67(4A) does not use the term "instalment warrant" except in the heading to the subsection.

Consequently, any borrowing arrangement by a superannuation fund that satisfies the requirements set out in the above new subsection ("a complying loan") will qualify for the exception to the prohibition against borrowing, even if it does not constitute an instalment warrant as traditionally understood.

Complying loan requirements

In effect, subsection 67(4A) provides that a borrowing by the trustee of a superannuation fund is not prohibited by subsection 67(1) (that is, it is a complying loan) where:

- the borrowed money is applied to the acquisition of an asset;
- the asset is of a type which the trustee is permitted to acquire (that is, it is not an asset acquired from a related party in breach of section 66 of the SIS Act, or an in-house asset acquired in breach of the in-house asset rules in Part 8 of the SIS Act);
- the trustee is not the legal owner of the asset, but rather the asset must be held on trust so that the trustee acquires a beneficial interest in it;
- the trustee has the right (without any obligation) to acquire legal ownership of the asset by making one or more payments after acquiring the beneficial interest; and
- the lender's rights against the trustee for default under the loan are limited to rights in respect of the asset (that is, the loan is limited recourse).

There is also scope within subsection 67(4A) for the original asset to be disposed of and substituted by a replacement asset.

What is left unspecified

The provisions of the new subsection 67(4A) are drafted broadly, so that in addition to the traditional instalment warrants described above, many other borrowing arrangements would be covered.

The Instalment Warrant Revolution and its impact on superannuation Continued

In particular, subsection 67(4A) is silent and therefore allows for flexibility in relation to both the identity of the legal owner of the asset, and also in relation to the identity of the lender.

This subsection is also silent and so allows for flexibility in relation to various other points, such as the amount of the payments that the trustee of the fund must make in order to acquire the asset, the term of the loan, the loan's interest rate, etc.

Gearing of a superannuation fund

There are many different ways in which a superannuation fund might be geared, given the flexibility inherent in subsection 67(4A). Beyond the basic practical requirement of leveraging the existing assets in the fund to acquire a more valuable asset than would otherwise be possible, there are many possibilities, including the following:

- direct loan from bank (the most straightforward arrangement, where the trustee borrows from a bank to acquire an asset on-market from an unrelated Vendor);
- indirect loan from bank (where a member of the fund or other related party borrows from a bank, and the member then makes a limited recourse loan to the fund's trustee);
- direct loan from related party (where a fund member invests via the fund by making a loan to the fund under subsection 67(4A), to avoid the contribution caps that may otherwise apply);
- Division 7A compliant loan under subsection 67(4A) from related private company (where the existing non-superannuation monies in question are currently in the form of retained profits of a private company controlled by a member of the fund);
- business real property ("BRP") acquired from a related party using a complying loan. (BRP may be acquired by a SMSF from a related party without breaching section 66 of the SIS Act).

Another possible strategy is for one SMSF to lend to another SMSF, so that the "lender" referred to in subsection 67(4A) is a SMSF. This strategy could be considered by an accountant or other adviser who acts for two or more SMSFs. However, our view is that the SMSFs in question should not be related to each other, otherwise in-house asset issues may arise, notwithstanding the recent changes to the SIS Act.

Detailed advice should be obtained to ensure that the proposed strategy in question complies with subsection 67(4A) and is properly documented.

Other SIS Act provisions plus other issues

Any proposed complying loan strategy must also satisfy the other provisions of the SIS Act apart from subsection 67(4A). In particular, the trustee of the fund must consider:

- in-house asset rule
In addition to inserting subsection 67(4A) into the SIS Act, the Amending Act modified section 71 by inserting subsection 71(8) so that the interest of the fund's trustee in the trust upon which the legal owner of the asset holds the asset is not an in-house asset of the fund. Therefore, an investment in a "related trust" which is part of an eligible complying loan arrangement will only be an in-house asset if the underlying asset would be an in-house asset if the fund invested in it directly.
- arm's-length dealings
Under section 109 of the SIS Act, all investments of a superannuation fund must be done on arm's-length terms. This is particularly relevant to the terms of the loan in question, and the amount of interest to be payable.
- section 66 of the SIS Act
This section generally prohibits a fund acquiring an asset from a related party. As stated above, the asset that is the subject of

the complying loan arrangement could not be an asset that is acquired from a related party such as a member in breach of section 66.

Also, the trustee is required to always have regard to the "prudent person" test that is set out in section 52 of the SIS Act, and any complying loan arrangement must be consistent with the fund's written investment strategy.

Finally, any proposed complying loan strategy may possibly have tax implications, including stamp duty, CGT, GST and land tax, and detailed advice should also be sought in this regard.

In conclusion, the recent legislative changes that have enabled complying loans to be made have opened up significant new investment opportunities for superannuation funds. Nevertheless, whether a complying loan arrangement is an appropriate investment for a fund depends on many factors, and detailed advice should be obtained to determine whether a fund should proceed with a complying loan arrangement, and if so, to ensure that it is properly documented and complies with subsection 67(4A).

Further info

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