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Direct Gearing of Super Funds: The Instalment Warrant Revolution

A paper presented by Denis Barlin at the 2009 SPAA National Conference in March 2009

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1 Introduction

Recent amendments to the *Superannuation Industry (Supervision) Act 1993* (Cth) ('**the SIS Act**') by the *Tax Laws Amendment (2007 Measures No 4) Bill 2007* (Cth) ('**the Bill'**) allow trustees of superannuation funds to invest in certain geared investments which were previously prohibited. Initially conceived to address problems caused by 'instalment warrants', the new rules permit many other direct borrowing strategies by fund trustees. Potential underlying investments include all asset classes permissible under the SIS Act, for example, real estate. This represents a paradigm shift in the regulatory attitude towards the gearing of superannuation funds.

This paper deals principally with instalment warrants and their structuring for superannuation and tax purposes. The paper does not deal with the *Corporations Act 2001* (Cth) issues which arise such as:

- Whether an Australian Financial Services Licence is necessary to deal with financial products which might satisfy the new superannuation requirements; and
- Whether a Product Disclosure Statement is necessary in respect of particular arrangements.

These are important issues and must be addressed when considering the use of a warrant approach to an investment.

2 What are 'instalment warrants'?

The term 'instalment warrant' is a label used to describe a range of financial products. As a result, it is difficult to provide a definitive definition or description of an 'instalment warrant'. It is the specific terms of the particular product, which are limited to the imagination of the product manufacturers. However, on a broad analysis of some product rulings relating to 'instalment warrants':

- They give an investor an interest in the underlying assets by payment of instalments during the life of the warrant.
- The underlying property is held by a 'security trustee' (or bare trustee), with the investor holding the 'warrant' – essentially a financial product.
- Generally, the investor is required to pay the first instalment upon application. Typically, the first instalment consists partly of the purchase price of the underlying asset, interest and any other borrowing costs (and sometimes a put option).
- The underlying property, held by the security trustee is subject to a charge, with amounts lent against the underlying property.
- The amounts lent are limited recourse in nature – usually limited to the value of the underlying property.
- The investor is liable for interest payments referable to the lending.

There are different types of instalments are typically created via three methods, being 'cash applications', 'shareholder applications' and 'roll-over applications'. The 'typical' arrangement is as described below:

(a) Cash Applications:

The investor begins with cash, and no exposure to the underlying property that is held subject to the instalment warrant application.

Instalment prices reflect a percentage of the market value of the underlying asset.

Upon the initial instalment payment, where the investor only pays a portion of the value of the underlying asset, the financier lends the balance (and the investor will incur borrowing fees and interest on this loan) with the financier taking as security interest in the underlying assets.

The instalment payment goes towards the prepayment of interest, payment of borrowing fees and the purchase of the underlying asset.

The borrowing fees and interest component are usually prepaid components.

The warrant issuer purchases the underlying asset on trust for the investor.

(b) Shareholder Applications:

The investor transfers legal title of an asset (that becomes the underlying asset) that the investor already holds to the security trustee. The financier will lend (the final instalment portion amount) to the investor and the financier takes as security interest in the underlying asset.

The proceeds of the loan are used to pay the interest (prepayment), borrowing fees and payment of a cash back amount to the investor to be used for investment purposes.

The underlying asset is held subject to the warrant (trust) relationship by the security trustee for the investor.

The loan is made on a limited recourse basis, secured by mortgage over the underlying asset, which will be held by a trustee as nominee for the investor.

(c) Roll-over Applications:

Roll-over applications usually occur when the term of an instalment warrant is over, and the investor who holds the instalment warrant rolls over into new issue / series of instalment warrant. A roll-over allows the investor to defer the final instalment on the previous investment.

The financier lends the final instalment component to the investor and the financier takes a security interest over the underlying asset.

The proceeds of the loan are used to pay the interest (prepayment), the borrowing fees and payment of the final instalment of the previous instalment warrant.

The underlying asset is held subject to the warrant (trust) relationship by the security trustee for the investor.

The loan is made on a limited recourse basis, secured by mortgage over the underlying asset, which will be held by a trustee as nominee for the investor.

(d) At maturity of an instalment warrant

At maturity the investor will usually have a few options:

(1) Pay the final instalment:

The loan will be repaid and the security over the underlying asset will be removed and the underlying assets are transferred to the investor's name.

(2) Roll over:

The underlying asset is not sold, rather the previous instalment warrant is cancelled and will be issued with a new warrant by the warrant issuer.

(3) Do nothing:

At maturity, if the final instalment is not made, the investors underlying asset is sold with any surplus remaining (after the repayment of the final instalment and other costs associated) will be provided to the investor. If the sale proceeds are insufficient to repay the loan, the financier has no recourse against the investor to recover the shortfall.

The final instalment is usually fixed and payment of the final instalment is optional. The final instalment is usually equal to the loan amount on the date of the final instalment is made. Upon the payment of the final instalment, the underlying asset gets transferred to the investor and the investor becomes the legal owner at this point.

The investor is typically be entitled to the returns (e.g. dividends and the franking credits attached) referable to the underlying property.

3 Investment restrictions - issues to consider when a superannuation fund invests in an instalment warrant

In the context of investment restrictions that apply to trustees of self-managed superannuation funds, apart from the general issues regarding whether such investments are suitable and fall within a superannuation fund's investment objective, there are two specific issues that need to be considered in the context of investments into 'instalment warrants', being:

- Whether there is a charge over an asset of a superannuation fund, which is prohibited by Regulation 13.14 of the SIS Regulations; and
- Whether there is a borrowing by a superannuation fund, which is prohibited by section 67 of the SIS Act.

4 Background

On 3 November 2006, the Minister for Revenue and Assistant Treasurer, the Hon. Peter Dutton, M.P. in Press Release No. 078 ('**the Press Release**') announced that instalment warrants contain an element of borrowing, and are therefore a prohibited investment for superannuation funds. This is notwithstanding longstanding practice and that '*Over a number of years instalment warrants have been marketed to superannuation funds — particularly to self managed superannuation funds (SMSFs).*'[1]

Further, both the Australian Prudential Regulation Authority and the Australian Taxation Office (collectively '**the Regulator**'), both being the regulators of the superannuation industry, had previously formed the view that instalment warrants did not involve to a 'borrowing'.

Indeed, the Regulator had issued guidelines as to what constitutes a borrowing for the purposes of section 67 of the SIS Act. The Regulator, in Superannuation Circular No II.D.4 entitled *Borrowing by superannuation entities* ('**the Borrowings Circular**'), considered that not all liabilities incurred by a superannuation fund would be a 'borrowing'. As an example, the Regulator at paragraph 16 of the Borrowings Circular distinguished between 'borrowings' and other debts:

> *'… in general ... a borrowing involves receiving a payment from someone in the context of a lender/borrower relationship on the basis that it will be repaid. A transaction that gives rise to a debtor/creditor relationship does not necessarily give rise to a lender/borrower relationship and hence does not necessarily represent a borrowing for the purpose of the restriction.'*

Further, the Regulator, at paragraph 17 of the Borrowings Circular, provided examples of borrowings, which includes a loan (whether secured or unsecured) and a bank overdraft (in normal circumstances). However, at paragraph 19 of the Borrowings Circular, the Regulator considered that the following would not be a borrowing:

> *'… amounts paid on behalf of, or owed by, regulated superannuation funds … [that include] … the purchase by a trustee of property where ownership of the property passes to the trustee before the instalments are finalised. Under this example, an investment in* ***endowment warrants or instalment receipts*** *may not be considered borrowing. It is necessary to check the obligations that lie with the purchaser to meet the instalment(s), as these determine whether the investment is a borrowing. Where the* ***remaining instalment(s) is not "compulsory"*** *and the* ***warrant / receipt holder receives the value of the warrant / receipt (less handling or sales costs)*** *on "default", APRA considers the warrant / receipt does not constitute a borrowing.'* [emphasis added]

Further, the Regulator at paragraph 6 of the Borrowings Circular gives examples of endowment warrants and instalment warrants as not involving borrowings by a Fund. The Regulator reiterated the views that it expressed in the Borrowings Circular regarding instalment warrants in the *Guidelines on Instalment Warrants for Superannuation Trustees* ('**Guidelines**'):

> *'… prohibition on borrowing was developed before many currently available geared products had been developed … The regulators had previously taken the view that a superannuation fund investment in an instalment warrant* ***may not*** *constitute a borrowing under section of the SIS Act.'* [emphasis added]

[1] See also paragraph 3.6 of the Explanatory Memorandum.

5 The prohibition against borrowing

Notwithstanding the change in the Government's view as announced in the Press Release, the Bill amended the SIS Act so as to ensure that investments in instalment warrants do not breach the prohibition against trustees of regulated superannuation funds from borrowing. Subsection 67(1) of the SIS Act expressed the prohibition, by providing that:

'… a trustee of a regulated superannuation fund must not

(a) borrow money; or

(b) maintain an existing borrowing of money.'

However, there are a number of exceptions to the prohibition contained in subsection 67(1) of the SIS Act, which includes (as a result of the enactment of the Bill), subsection 67(4A) of the SIS Act, which provides that subsection 67(1) of the SIS Act

'… 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.'

A summary of the key features of subsection 67(4A) of the SIS Act is provided in paragraph 3.12 of the Explanatory Memorandum:

'An exception to the prohibition on borrowing in section 67 of the Superannuation Industry (Supervision) Act 1993 will allow a superannuation fund trustee to borrow money in accordance with an arrangement that has the following features:

- *the borrowing is used to acquire an asset that is held on trust so that the superannuation fund trustee receives a beneficial interest and a right to acquire the legal ownership of the asset (or any replacement) through the payment of instalments;*
- *the lender's recourse against the superannuation fund trustee in the event of default on the borrowing and related fees, or the exercise of rights by the fund trustee, is limited to rights relating to the asset; and*
- *the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly.'*

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6 The legal relationships required to obtain the borrowing carve-out

It is essential to consider the legal relationships that arise when seeking to avail oneself of the borrowing carve-out in subsection 67(4A) of the SIS Act. The provisions require the following conditions to be satisfied:

Condition	Description
One	A trustee of a superannuation fund borrows money (or indeed maintains a borrowing of money).
Two	The asset that has been acquired by the borrowed money.
Three	The asset that has been acquired is held on trust so that the trustee of the superannuation fund has a 'beneficial interest' in the asset.
Four	The trustee of the superannuation fund has an option (i.e. a right to acquire) the 'legal ownership' by making further (instalment) payments.
Five	The right of the lender is limited in recourse – to the asset acquired and held by the trustee.
Six	If, under the arrangement, the trustee of a superannuation fund has a right relating to the asset (other than a right to acquire the underlying asset) – the rights of the lender against the trustee of the superannuation fund are limited to rights relating asset.

That is:

- The trustee of the superannuation fund borrows to acquire the underlying asset;
- The trustee of the superannuation fund needs to have the 'beneficial interest' in the underlying asset;
- The underlying asset is held on trust (indeed – bare trust) for the benefit of the trustee of the superannuation fund (held by a 'Security Trustee');
- The trustee of the superannuation fund has an option to acquire the underlying asset after paying the loan amount;
- The lenders rights with respect to the borrowing are limited in recourse, to the underlying asset;
- Any rights that the trustee of a superannuation fund has to the underlying asset (except the option to acquire) may be subrogated in the lender, but only to the extent that the rights apply to the underlying asset.

The Security Trustee needs to hold the legal title in the underlying property. The Security Trustee acts as a 'bare trustee' with respect to the underlying property, as the Security does no more (under the trust relationship) than hold the legal title in the underlying property. It is also

essential from a taxation perspective (see discussion below) that the relationship as between the Security Trustee and the Investor with respect to the underlying property is a 'bare trust' - i.e. the Investor is 'absolutely entitled' to the underlying asset and the Security Trustee has no active duty with respect to the underlying asset.

There are a number of contractual relationships that need to be established. A lender / borrower relationship needs to be established as between the lender and the Investor. Under that relationship, the Security Trustee is prohibited from dealing with the underlying asset on behalf of the Investor, unless the Security Trustee is required to do something which involves the discharge of the loan (for example):

- the lender exercises a power of sale with respect to the underlying asset;
- the Investor pays the outstanding amount and the legal title in the underlying asset transferred to the Investor; or
- the Investor wants to dispose of the underlying asset and repay the outstanding loan.

It needs to be ensured that the only right that the lender has (including with respect to the repayment of the loan) is limited to the underlying asset. None of the other assets of the Investor can be at risk. As a result, all of the Investor, the Security Trustee and the lender need to enter into a contractual relationship.

Further, and in some situations, the Security Trustee may be granted a power of attorney by the Investor with respect to the underlying asset, until the borrowing is discharged and the legal title is transferred to the Investor.

The Investor needs to be able to acquire the legal title in the underlying property at any time.

Product Ruling PR 2005/96 entitled *Income tax: tax consequences of investing in ABN AMRO Rolling Instalment Warrants IZY Series 2005 Product Disclosure Statement – Cash Applicants and Secondary Market Purchasers* (withdrawn) ('PR 2005/96')[2] outlines the arrangements and the participants involved in the particular warrant product. Paragraphs 18 to 20 of PR 2005/96 outline the participants in the product:

> *'18. ABN AMRO …* [i.e. the financier] *… is the Issuer of the ABN AMRO IZY Rolling Instalments. ABN AMRO is also the provider of the Loans to Investors to fund the acquisition of the Underlying Parcel …* [i.e. the asset to be held subject to the warrant arrangement] *….*
>
> *19. ABNED Nominees Pty Limited …* [i.e. the 'bare' trustee in the warrant relationship] *… holds the legal title to the Underlying Parcel as Security Trustee and as nominee for the Investor.*
>
> *20. The Investors may be individuals, companies, trusts or superannuation funds.'*

Sub-paragraph 17(b) of PR 2005/96 provides that:

> *'Under a Cash Application, a Cash Applicant …*[e.g. a trustee of a superannuation fund] *… pays the First Payment …* [i.e. the initial 'instalment'] *… and draws down the Loan made by ABN AMRO …*[i.e. the financier]. *The First Payment and the Loan Amount is applied toward the purchase of the Underlying Parcel …* [i.e. the asset to be held subject to the warrant

[2] Paragraph 20 of PR 2005/96 provides that the ëÖ *Investors may be individuals, companies, trusts or superannuation fundsí*.

arrangement] *… , payment of the First Interest Amount and payment of the Capital Protection Fee and Borrowing Fee (if any).*

ABN AMRO … [i.e. the financier] *… purchases the Underlying Parcel …* [i.e. the asset to be held subject to the warrant arrangement] *… in the name of the Security Trustee …* [i.e. the 'bare' trustee in the warrant relationship] *… for the benefit of the Cash Applicant …* [e.g. a trustee of a superannuation trust] *… and takes a security interest over the Underlying Parcel …* [the asset to be held subject to the warrant arrangement] *…'.*

Further, at sub-paragraph 17(e) of PR 2005/96:

'… repayment of the Loan will be secured by a mortgage over the Underlying Parcel …[i.e. the asset to be held subject to the warrant arrangement] *… Legal title to the Underlying Parcel will be held by the Security Trustee …* [i.e. the 'bare' trustee in the warrant relationship] *… on trust for the Investor. Each trust and each Underlying Parcel to which it relates will be kept as a separate trust and there will be no pooling of interests of property to which the trust relates'.*

Product Ruling PR 2005/40 entitled *Income tax: tax consequences of investing in Macquarie Regular Instalment Warrants IMF Series 2004 Product Disclosure Statement - cash applicants and on-market purchasers* (withdrawn) ('**PR 2005/40'**) discusses the relationships and obligations that arise under that specific product. It is observed at paragraph 16(d) of PR 2005/40 that:

'… under a Cash Application, the Cash Applicant … [e.g. a trustee of a superannuation fund] *… pays the varying First Payment …* [i.e. the initial 'instalment']. *Macquarie …* [i.e. the financier] *… lends the Completion Payment amount (which is the current Loan Amount) to the Cash Applicant and takes a security interest over the Underlying Share …* [i.e. the asset to be held subject to the warrant arrangement] *… . Proceeds of the Loan and the First Payment from the Cash Applicant are applied toward the purchase of the Underlying Share, prepayment of interest to Macquarie and the payment of borrowing fees to Macquarie. Macquarie buys the underlying share in the name of the Security Trustee* [i.e. the '*bare'* trustee in the warrant relationship]. *The Macquarie IMF instalment is issued in the name of the cash Applicant.'.*

Sub-paragraph 16(f) of PR 2005/40 provides that:

'… repayment of the Loan will be secured by a mortgage over the Underlying Share which will be held by the Security Trustee as trustee for the Holder. Each trust and each Underlying Share to which it relates will be kept as a separate trust and there will be no pooling of interests or property to which the trust relates.'

The 'Loan' in the warrant arrangement described in PR 2005/40 is described in paragraph 16(g):

'the Loan is provided on a limited recourse basis such that Macquarie's right to repayment of the Loan is limited to the amount it can obtain by enforcing its right in respect of the Mortgaged Property'.

Product Ruling PR 2006/5 entitled *Income tax: tax consequences of investing in Westpac 'SWB' Series Self-Funding Instalments - 2005 Product Disclosure Statement - cash applicants and on-*

market purchasers (withdrawn) ('**PR 2006/5'**)[3] is another example. Paragraphs 16 to 18 of PR 2006/5 describe the participants involved in the product:

> *'16. Westpac …* [i.e. the financier] *… is the Issuer of the Westpac SWB Instalments and is also the provider of the Loans to Holders …* [e.g. a trustee of a superannuation fund] *… to fund the acquisition of the Underlying Parcel …* [i.e. asset to be held subject to the warrant relationship].
>
> *17. Westpac Custodian Nominees Limited* ,,,[i.e. the 'bare' trustee in the warrant relationship] *…, as Security Trustee, holds the legal title to each Underlying Parcel for each Holder.*
>
> *18. The Holders may be individuals, companies, trusts or superannuation funds'.*

Sub-paragraph 15(a) of PR 2006/5:

> *'Westpac SWB Instalments …* [i.e. the warrant] *… are a leveraged investment under which a Holder …* [e.g. a trustee of a superannuation fund] *… acquires a beneficial interest in shares and/or stapled securities listed on the ASX and/or units in certain listed trusts (Security) …* [i.e. asset to be held subject to the warrant relationship] *… using a limited recourse Loan made by Westpac …* [i.e. the financier]*. Where the Security includes a stapled security, the stapled security comprises shares and/or units that are jointly listed for quotation on the ASX. The Security, together with any Accretions, is referred to as the 'Underlying Parcel'.*

Sub-paragraph 15(g) of PR 2006/5:

> *'… repayment of the Loan is secured by a mortgage over the Underlying Parcel. Legal title to the Underlying Parcel is held by the Security Trustee* ,,,[i.e. the 'bare' trustee in the warrant relationship] *… on trust for the Holder. Each Underlying Parcel is held on a Separate Trust and there is no pooling of interests or property to which the trust relates …'.*

Subparagraph 15(i) of PR 2006/5:

> *'… the Loan is provided on a limited recourse basis so that if the Holder does not make the Completion Payment, Westpac's right to repayment is limited to the proceeds which it can obtain from enforcing its Security Interest over the Underlying Parcel. If the Holder provides a Completion Notice to Westpac, however, Westpac is entitled to recover the Completion Payment from the Holder in full …'.*

[3] Paragraph 18 of PR 2006/5 provides that the ëÖ Holders may be individuals, companies, trusts or superannuation fundsí.

7 What is a 'bare trust' relationship?

As discussed above, the warrant relationship is a bare trust relationship as between the Security Trustee and the Investor with respect to the underlying asset.

The Commissioner of Taxation ('**the Commissioner**') outlined his views with respect to the passing of property held subject to bare trusts in draft Goods and Services Tax Ruling GSTR 2008/3 entitled *Goods and services tax: GST and bare trusts* ('**the GST Ruling**'). In doing so, the Commissioner defined the 'bare trust' relationship. The Commissioner at paragraph 1 of the GST Ruling outlines the situations in which the GST Ruling applies:

> *'This Ruling explains how the …* [GST Act] *… applies to supplies of real property involving bare trusts and similar trusts where the trustee has limited active duties and acts solely at the direction of the beneficiary or beneficiaries'.*

The Commissioner at paragraphs 5 and 6 of the GST Ruling explains when the GST Ruling Does not apply, by stating at paragraph 5 of the GST Ruling that*: 'This Ruling does not deal with transactions in relation to trust property where the activities of the trust amount to the trust carrying on an enterprise involving the trust property'*. Further, the Commissioner at paragraph 6 of the GST Ruling observes that the GST Ruling '*does not deal with managed investment schemes*'.

The Commissioner at paragraph 11 of the GST Ruling explains what he considers a 'bare trust' to be:

> *'An entity (B) that carries on an enterprise may, for reasons of convenience or anonymity, arrange for real property which is to be used in its enterprise to be acquired by another entity (T) to hold on trust for B –* ***that is, subject to an obligation to transfer legal title to the asset to B, or to a third party if B so directs, and with no other active duties to perform'*** [emphasis added].

The Commissioner at paragraph 12 of the GST Ruling observes that the types of trusts dealt with in the GST Ruling may not be strict bare trust relationships:

> *'Alternatively, the trust may not strictly be a bare trust, because the trustee has minor active duties to perform, but nevertheless the trustee is required to act at the direction of the beneficiary in dealing with title to the trust property. Where this draft Ruling refers to 'bare trusts' it should also be taken to refer to trusts of this kind which may not strictly fall within accepted definitions of bare trusts but share similar features. The key point is that the trustee only acts at the direction of the beneficiary in respect of the relevant dealings in the trust property and has no independent role in respect of the trust property.'*

That is, the Commissioner seems to indicate that a 'bare trust' relationship is one in which a trustee has no active duties to perform. The New South Wales Supreme Court in *Corumo Holdings Pty Ltd v C Itoh Ltd* (1991) 24 NSWLR 370 at 398 considered that as a matter of strict logic, almost no situation can be postulated where a trustee in some circumstances does not have active duties to perform by (for example) being immediately bound to transfer trust property to an absolutely entitled beneficiary. Meagher JA in *Corumo Holdings* observed that:

> *'The question is whether that trust is a 'bare trust' … A 'bare trust' is one in which the trustee has no active duties to perform and is usually contrasted with a trust where there are such active duties. … the precise nuances of the phrase …* [bare trust] *… must depend on the context in which it is found. As a matter of strict logic a person in Mr Stapleton's position …*

> [i.e. the 'bare trustee'] … *would theoretically have been in a position where he had an active independent duty to perform in some circumstances, for example if he found himself so situated that he had to vote at a formal meeting and C Itoh had declined to instruct him how to exercise his vote.* ***But, as a matter of strict logic, almost no situation can be postulated where a trustee cannot in some circumstances have active duties to perform. The applicants would have the phrase confined to situations where the trustee was immediately bound to transfer the share to his beneficiary. But this, in my view, is too narrow a construction, and would result in reading down the phrase so that it applied only to situations which almost never occur****.'* [emphasis added]

Further, Meagher JA submitted that a bare trust relationship occurs when a *'… trustee is no more than a nominee or cipher, in a common-sense commercial view*'. Gummow J in *Re Helen Kaye Herdegen and Kenneth John Herdegen v Commissioner of Taxation* [1988] FCA 419 observed that:

> *'What is meant in these situations by saying that the trustee holds the property without any duties to perform other than to convey the property to the beneficiary or as the beneficiary directs? … 'It is of course true that* ***so long as a trustee holds property on trust he always retains his legal duties, namely, to exercise reasonable care over the property, either by maintaining it or by investing it; he cannot divest himself of these duties.*** *The reference, however, is to duties which the settlor has enumerated. For example, the settlor may have required that the beneficiary be maintained until he reaches the age of majority, when he is entitled to call for capital and income. The trustee is then bare or naked of these active duties decreed by the settlor. If the trustee possesses his legal duties only for the purpose of guarding the property, prior to the conveyance to the beneficiary, these duties are said to be passive'.* [emphasis added]

That is, there may be some duties, which may indeed be 'active' duties imposed on a trustee of a bare trust relationship. It has been held that even if a beneficiary is absolutely entitled to trust property, the beneficiary may not give directions to a trustee with respect to the administration of the trust. For example, in *re Brockbank. Ward v Bates* [1948] 1 Ch 206, the Court held that beneficiaries who are absolutely entitled to trust property are not entitled to control the exercise by their trustee of their fiduciary power to appoint new trustees:

> *'The two alternative grounds of relief claimed are sought to be justified by the following argument: It is said that where all the beneficiaries concur, they may force a trustee to retire, compel his removal and direct the trustees, having the power to nominate their successors, to appoint as such successors such person or person or corporation as may be indicated by the beneficiaries, and it is suggested that the trustees have no option but to comply. I do not follow this. The power of nominating a new trustee is a discretionary power, and, in my opinion is no longer exercisable and, indeed, can no longer exist if it has become one of which the exercise can be dictated by others. But then it is said that the beneficiaries can direct the trustees to transfer the trust property either to themselves absolutely, or to any other person or persons or corporation, upon trusts identical with or corresponding to the trusts of the testators will. I agree …'.*

Whilst the active duty test is important in determining whether a bare trust relationship exists, it is also important to determine whether the trustee has an interest with respect to the assets held subject to the trust relationship. Gummow J in *Herdegen v Federal Commissioner of Taxation* 88 ATC 4995 at 5003 observed that:

> *'Today the* ***usually accepted meaning of 'bare' trust is a trust under which the trustee or trustees hold property without any interest therein****, other than that existing by reason of*

> *the office and the legal title as trustee, and without any duty or further duty to perform, except to convey it upon demand to the beneficiary or beneficiaries or as directed by them, for example, on sale to a third party. The beneficiaries may of course hold the equitable interest upon a sub-trust for others or himself and others … The term is usually used in relation to trusts created by express declaration. But it has been said that the assignor under an agreement for value for assignment of so-called 'future' property becomes, on acquisition of the title to the property, trustee of that property for the assignee … and this trust would answer the description of a bare trust. Also, the term 'bare trust' may be used fairly to describe the position occupied by a person holding the title to property under a resulting trust flowing from the provision by the beneficiary of the purchase money for the property.'*
> [emphasis added]

However, we note Gummow J's observations in *Herdegen's case*, being that 'bare' trustees are:

> *'… those trustees who have no interest in the trust assets other than that existing by reason of the office and legal title as trustee and who never have had active duties to perform or who have ceased to have those duties, such that in either case the property awaits transfer to the beneficiaries or at their direction.*
>
> *It may be, in a given case, that a trustee is entitled either by statutory provision or the terms of a trust instrument or court order, to charge fees and to have a lien or charge upon the trust assets for those fees. The trustee may also in a given case have a lien upon the trust assets for costs properly incurred in performance of the obligation to safeguard the trust property. It is unnecessary in the present case to decide whether the existence of such a lien or charge in the circumstances described would take a trustee outside what would otherwise be the category of "bare" trustee …'.*

As a result, any asset held subject to a 'typical' Warrant arrangement is held subject to a 'bare trust' relationship. The Security Trustee does not have any active duties with respect to the assets pursuant to the trust arrangement. Rather, any duties that the Security Trustee may have with respect to any assets held subject to a Warrant are pursuant to contractual arrangements with respect to the borrowings.

8 Borrowing carve-out - whether real property may be subject to an instalment warrant

Apart from holding assets which are prohibited under the SIS Act[4], the amendments to the SIS Act do not discriminate on the basis of the character of assets that may be subject to an instalment warrant. Paragraph 3.1 of the Explanatory Memorandum[5] provides that the amendments to the SIS Act '*… allow[s] superannuation funds to invest in instalment warrants of a limited recourse nature* ***over any asset a fund would be permitted to invest in directly***' [emphasis added]. That is, as long as the property held subject to a warrant is one which trustees of superannuation funds are permitted to invest in (such as real property), then the trustee is permitted to invest in the instalment warrant.

[4] For example, assets which were held by a related party of a superannuation fund: see section 66 of the SIS Act.
[5] See also paragraph 13.12 of the Explanatory Memorandum, which provides that ëÖ *the asset (or any replacement) must be one which the superannuation fund trustee is permitted to acquire and hold directly.*í

9 In-House Asset Restrictions

Further issues to consider when a trustee of a superannuation fund invests in 'instalment warrant' products include the application of the 'in-house asset test'. Specifically:

- whether an investment / interest that a trustee of a superannuation fund makes in an instalment warrant may be an 'in-house asset'; and
- whether an instalment warrant relationship may be 'looked through' where the asset subject to an instalment warrant is itself an in-house asset (i.e. the underlying asset) may be included in determining whether the in-house asset investment threshold has been breached.

Broadly speaking, and considering the typical terms of an instalment warrant, warrants over listed shares are not subject to the in-house asset restrictions.

However, whilst real property subject to instalment warrants will be a 'related trust' and therefore fall within the definition of an in-house asset, the subsection 71(8) of the SIS Act cause such instalment warrants to fall outside the application of the in-house asset restrictions where the underlying asset is not itself an in-house asset.

If an asset held subject to an instalment warrant (trust relationship) is itself an 'in-house asset' (i.e. a related trust) of a superannuation fund investor, the instalment warrant will be considered to be an 'in-house asset'.

10 Whether an investment in an instalment warrant is an 'in-house asset'

Part 8 of the SIS Act is concerned with the '… *rules about the level of the in-house assets of regulated superannuation funds*'. Generally speaking, regulated superannuation funds may not hold more than 5% of the market value of their assets as 'in-house assets'.

Subsection 71(1) of the SIS Act provides the 'basic meaning' of the term 'in-house asset':

> *'… an in-house asset of a superannuation fund is an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party of the fund …'.*

The Regulators views with respect to 'in-house assets' is contained in Superannuation Circular No II.D.6 entitled *In-house assets* ('**In-House Asset Circular**'). Paragraph 10 of the In-House Asset Circular discusses the basic definition of 'in-house asset':

> *'An 'in-house asset' of a fund is:*
>
> - *A loan to, or an investment in, a related party of the fund; or*
> - *An investment in a related trust of the fund; or*
> - *An asset of the fund subject to a lease or lease arrangement between the trustee of the fund and a related party of the fund*
>
> *Other than an asset which is excepted under section 71 of SIS …'.*

As previously mentioned, instalment warrants are trusts (indeed, 'bare' trusts). The issue is whether an instalment warrant is a 'related trust' with respect to a superannuation fund investor. The term 'related trust' is defined in section 10 of the SIS Act:

> *'Related trust, of a superannuation fund, means a trust that a member or a standard employer-sponsor of the fund controls (within the meaning of section 70E), other than an excluded instalment trust of the fund.'*

To the extent that a trust is an 'excluded instalment trust', notwithstanding that it may be a 'related trust', it is carved-out from the application of the definition of that term. The term 'excluded instalment trust' is defined in section 10 of the SIS Act as:

> '… a *trust*:
>
> *(a) that arises because a trustee or investment manager of the superannuation fund makes an investment under which a listed security (within the meaning of subsection 66(5)) (the underlying security) is held in trust until the purchase price of the underlying security is fully paid; and*
>
> *(b) the underlying security, the property derived from the underlying security, is the only trust property; and*
>
> *(c) where an investment in the underlying security held in trust would not be an in-house asset of the superannuation fund.'*

That is, to the extent that an instalment warrant has, as its underlying property, listed shares, the instalment warrant will not be considered to be a 'related trust', with the result that the investment in the instalment warrant will not be subject to the in-house asset rules.

However, if the underlying property is not listed shares (e.g. it is real property) then it must be determined whether the instalment warrant (trust) relationship is controlled by a member of a superannuation fund that is an instalment warrant investor. Subsection 70E(2) of the SIS Act provides that:

> *'… an entity controls a trust if:*
>
> *(a) a group in relation to the entity has a fixed entitlement to more than 50% of the capital or income of the trust; or*
>
> *(b) the trustee of the trust, or a majority of the trustees of the trust, is accustomed or under an obligation (whether formal or informal), or might reasonably be expected, to act in accordance with the directions, instructions or wishes of a group in relation to the entity (whether those directions, instructions or wishes are, or might reasonably be expected to be, communicated directly or through interposed companies, partnerships or trusts); or*
>
> *(c) a group in relation to the entity is able to remove or appoint the trustee, or a majority of the trustees, of the trust.'*

An investor in an instalment warrant (except for those that are tailored) cannot either instruct or direct the security trustee to act in accordance with its wishes (paragraph 70E(2)(b) of the SIS Act), or remove or appoint a security trustee (paragraph 70E(2)(c) of the SIS Act). However, close regard needs to be given to whether an investor has a *'…fixed entitlement to more than 50% of the capital or income …*' referable to an instalment warrant.

The term 'fixed entitlement' is not defined in the SIS Act. However, as a general proposition, in order for a beneficiary of a trust to have a 'fixed entitlement', the beneficiary needs a 'vested and indefeasible interest' in the capital and / or the income of the trust estate. Hill J in *Dwight v FC of T* (1992) 37 FCR 178 observed that:

> *'The words 'vested' and 'indefeasible' in the context of trust law are technical legal words of limitation, which have a well understood meaning to property conveyancers.'*

Paragraphs 13.3 to 13.9 of the Explanatory Memorandum to the *Taxation Laws Amendment (Trust Loss and Other Deductions) Bill 1997* (Cth) provides an explanation of the meaning of the terms 'vested' and 'indefeasible':

> *'What is a fixed entitlement to income or capital of a trust?*
>
> *13.3 A person (the beneficiary) will have a fixed entitlement to either income or capital of a trust (whichever is applicable) where the beneficiary has a vested and indefeasible interest in a share of the income of the trust that the trust derives from time to time (i.e. current and future income), or a share of capital of the trust [subsection 272-5(1)] . The share that the person has an interest in is expressed as a percentage of the total income or capital (whichever is applicable) of the trust.*
>
> *What is a vested interest?*

13.4 A person has a vested interest in something if the person has a present right relating to the thing. Stated simply, a vested interest is one that is bound to take effect in possession at some point in time. A vested interest is to be contrasted with a 'contingent' interest which may never fall into possession. If an interest of a beneficiary in income or capital is the subject of a condition precedent, so that an event must occur before the interest becomes vested, the beneficiary does not have a vested interest to the income or capital since such an interest is instead 'contingent' upon the event occurring.

13.5 In traditional legal analysis, a person can be said to be either 'vested in possession' or 'vested in interest'. A present interest, i.e. one that is being enjoyed, is said to be 'vested in possession'; a future interest, i.e. one which gives its holder a present right to future enjoyment, is said to be 'vested in interest'. A person is vested in possession where the person has a right to immediate possession or enjoyment of the thing in question. In the definition of fixed entitlement, 'vested' includes both vested in possession and vested in interest.

13.6 Because vested interests include future interests, a person can have a vested interest in a thing even though the person's actual possession and enjoyment of the thing is delayed until some time in the future.

When is a vested interest indefeasible?

13.7 A vested interest is indefeasible where, in effect, it is not able to be lost. A vested interest is defeasible where it is subject to a condition subsequent that may lead to the entitlement being divested. A condition subsequent is an event that could occur after the interest is vested that would result in the entitlement being defeated, for example, on the occurrence of an event or the exercise of a power. For example, where a beneficiary's vested interest is able to be taken away by the exercise of a power by the trustee or any other person, the interest will not be a fixed entitlement.

13.8 Where the trustee exercises a power to accumulate income or capital of the trust in accordance with the trust deed, the accumulation does not result in a beneficiary's interest being taken away or defeased as long as the beneficiary nevertheless remains entitled at some future time to enjoy his or her share of the income or capital which has been accumulated.'

With respect to whether an interest was 'vested', it was observed in *Dwight v FC of T* (1992) 37 FCR 178 that:

'Estates may be vested in interest or vested in possession, the difference being between a present fixed right of future enjoyment where the estate is said to be vested in interest and a present right of present enjoyment of the right, where the estate is said to be vested in possession … A person with an interest in remainder, subject to a pre-existing life interest, has an interest which is vested in interest, but being a future interest is not yet vested in possession. That person's interest will vest in possession on the death of the life interest.'

We note that most instalment warrants provide that the investors 'receive' any income referable to the underlying property subject to an instalment warrant, the income may be used to discharge liabilities referable to the arrangement (e.g. interest expenses). On one view, such an arrangement means that the investor in the warrant has no right to the income referable to the underlying asset. However, we consider that the better view (particularly given the bare trust relationship), is that the investors have a 'fixed entitlement' to the income, but have directed / allowed the Security Trustee to deal with the income on its behalf.

We further note that the Commissioner considers that investors in instalment warrant arrangements, has a 'present entitlement' to the income derived from the underlying asset. For example, the Commissioner at paragraph 43 of Product Ruling PR 2005/27 entitled Income tax: tax consequences of investing in QuantumWarrants - 2005 Product Disclosure Statement (withdrawn) considered that:

> *'The Investors are presently entitled to all of the income derived from the Property. Therefore, section 97 will apply to assess the Investors on the income derived from the Property. The Security Trustee will not be subject to tax on this income.'*

In order to be considered 'presently entitlement', the beneficiaries need both a 'fixed entitlement', and the ability to call on that entitlement. Kitto J in *Taylor v FC of T* 70 ATC 4026 considered that 'present entitlement' included *'… an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it …*'. Further, it was observed at page 4176 that present entitlement to trust income is to:

> *'… income that was available for distribution regardless of whether the accounts necessary to enable its precise ascertainment had been completed at the end of the income year or whether it was actually held in a form ready for immediate payment …'.* [6]

Given that an investor in an instalment warrant has a 'present entitlement' to the income of the underlying asset, the investor will also be considered to have a 'fixed entitlement' to the income. As a result, an instalment warrant under which real property is held will be a 'related trust' of a superannuation fund investor.

[6] In *FC of T v Whiting & Ors* (1942 ñ 1943) 68 CLR 199 at 215, the High Court observed that:

> *Ö when the Act speaks of a beneficiary being presently entitled to a share in income, it refers to the right of a beneficiary to obtain immediate payment, rather than to the fact that a beneficiary has a vested interest Ö* [emphasis added]

It was held in *Taylor & Anor v FC of T* 70 ATC 4,026 at 4,030 that:

> *Ö épresently entitledí refers to an interest in possession in an amount of income that is legally ready for distribution so that the beneficiary would have a right to obtain payment of it if he were not under a disability.* [emphasis added]

Similarly, in *Totledge Pty Ltd v FC of T* 82 ATC 4168 the Court considered that income to which beneficiaries are épresently entitledí is é*Ö income that was available for distributioní*.

11 Impact of the Bill on the instalment warrants in which real property is the subject matter

The Act inserted a new subsection 71(8), which has the aim of looking through an instalment warrant relationship for the purposes of determining whether the underlying asset subject to an instalment warrant is an in-house asset. Subsection 71(8) of the SIS Act provides that:

> *'If, at a time:*
>
> *(a) an asset (the investment asset) of a superannuation fund is an investment in a related trust of the fund; and*
>
> *(b) the related trust is one described in paragraph 67(4A)(b) in connection with a borrowing, by the trustee of the fund, that is covered by subsection 67(4A); and*
>
> *(c) the only property of the related trust is the original asset or replacement described in that subsection;*
>
> *the investment asset is an in-house asset of the fund at the time only if the original asset or replacement described in subsection 67(4A) would be an in-house asset of the fund if it were an asset of the fund at the time.'*

That is, subsection 71(8) of the SIS Act will only apply to 'look through' an instalment warrant relationship if the instalment warrant itself is a 'related trust' of a superannuation fund investor. For the reasons discussed above, an instalment warrant where the underlying property is listed securities will not be a 'related trust'. However, if the underlying assets are not listed securities (e.g. real property), then the instalment warrant relationship will be a 'related trust' of a superannuation fund investor.

Subsection 71(8) of the SIS Act makes it clear that if the underlying asset of an instalment warrant is not an in-house asset (e.g. real property leased to a third party), then the instalment warrant itself will not be considered an in-house asset.

Paragraph 3.13 of the Explanatory Memorandum explains the effect of the proposed amendment:

> *'… the in-house assets rules are amended to provide that an investment in a related trust forming part of an instalment warrant arrangement which meets the requirements of the borrowing exception will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.'*

Further, paragraph 3.15 of the Explanatory Memorandum provides that:

> *'An investment in a related trust forming part of an instalment warrant arrangement … will only be an in-house asset under section 71 where the underlying asset would itself be an in-house asset of the fund if it were held directly.'*

Paragraph 3.16 of the Explanatory Memorandum provides that:

> *'This means an investment in an instalment warrant will not be automatically counted against the in-house asset limit. However, the new provisions will not allow fund trustees to circumvent the existing in-house asset rules. Where the underlying asset would have been an in-house asset had the superannuation fund invested in it directly, an investment in the instalment warrant will be an in-house asset. Where the acquisition of such an asset would*

breach the in-house asset rule if it were held directly, the investment in an instalment warrant over that same asset will not be permitted.'

Example 3.2 contained in the Explanatory Memorandum:

'Five per cent of the Fields Family Super Fund's assets are in-house assets for the purposes of section 71 of the Superannuation Industry (Supervision) Act 1993.

The trustee of the fund is prohibited from acquiring further in-house assets by section 83 of the Superannuation Industry (Supervision) Act 1993.

Therefore, the trustee cannot use an instalment warrant arrangement to acquire a beneficial interest in another in-house asset, for example, an investment in an instalment warrant over a share in a company controlled by a member of the Fields Family Super Fund, as this would breach the in-house asset restriction.

However, the trustee can use an instalment warrant arrangement to acquire a beneficial interest over an unrelated asset, for example, listed shares in an unrelated company. As the underlying asset would not be an in-house asset if held directly, the investment in an instalment warrant trust will not be an in-house asset and there will be no breach of the in-house asset restriction.'

That is, to the extent that the underlying asset held subject to an instalment warrant (trust relationship) is itself an in-house asset (i.e. a related trust) of a superannuation fund investor, the instalment warrant will be considered an 'in-house asset'.

However, if the underlying asset subject to an instalment warrant is not an in-house asset, then the investment in an instalment warrant by a superannuation fund will not also be an in-house asset.

12 What if 'business real property' is subject to an instalment warrant?

As noted above, subsection 71(8) of the SIS Act provides that if the underlying asset of an instalment warrant is not an in-house asset, then the instalment warrant itself will not be considered an in-house asset. However, 'business real property' is carved out of the definition of 'in-house asset'. As a result, business real property will not be an in-house asset notwithstanding that the business real property may (amongst other things) be subject to a lease between a trustee of a superannuation fund and a related party of a superannuation fund. As a result, if business real property (which is leased by a related party of a superannuation fund) is subject to an instalment warrant, then the instalment warrant will not be subject to the in-house asset rules.

The basic definition of the term 'in-house asset' is defined in subsection 71(1) of the SIS Act to be:

> *'… an in-house asset of a superannuation fund is an asset of the fund that is a loan to, or an investment in, a related party of the fund, an investment in a related trust of the fund, or an asset of the fund subject to a lease or lease arrangement between a trustee of the fund and a related party of the fund…'.*

Paragraph 71(1)(g) of the SIS Act provides that in-house assets do not include:

> *'… if the superannuation fund has fewer than 5 members – real property subject to a lease, or a lease arrangement enforceable by legal proceedings, between a trustee of the fund and a related party of the fund, if, throughout the term of the lease or lease arrangement, the property is business real property of the fund (within the meaning of subsection 66(5)) …'.*

The term 'business real property' is in turn defined in subsection 66(5) of the SIS Act as:

> *' … in relation to an entity, means:*
>
> *(a) any freehold or leasehold interest of the entity in real property; or*
>
> *(b) any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer; or*
>
> *(c) if another class of interest in relation to real property is prescribed by the regulations for the purpose of this paragraph – any interest belonging to that class that is held by the entity;*
>
> *where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of beneficiary of a trust estate.'*

As a result, if business real property, subject to a lease with a related party of the fund is held subject to an instalment warrant, then the instalment warrant itself will not be subject to the in-house asset rules.

13 Charging prohibition – Regulation 13.14 of the SIS Act

Part 3 of the SIS Act provides for "operating standards" applicable to trustees of superannuation funds (section 30 of the SIS Act). Subsection 31(1) of the SIS Act provides that the SIS Regulations may *'… prescribe standards applicable to regulated superannuation funds and to trustees … of those funds…'*. Subsection 31(2) of the SIS Act provides that the standards may relate to the *'… investment of assets of funds and the management of the investment …'*. Regulation 13.14 of the SIS Regulations, which is an operating standard for the purposes, of section 31 of the SIS Act provides that *'… the trustee of a fund must not give a charge over, or in relation to, an asset of the fund'*. The term 'charge' is defined in Regulation 13.11 of the SIS Regulations as including *'... a mortgage, lien or other encumbrance...'*.

In a warrant, the charge is over the underlying property, which is held by a security trustee (see for example PR 2002/90, 2004/3 and PR 2002/11). The charge is not over the warrants, which is held by the investor.

The Regulator in Media Release No 02.58 entitled *Super Regulators urge caution on instalment warrants* dated 16 December 2002 observed that:

> *'The use of a fund's existing equity holdings to purchase instalment warrants, may breach section 67 of the* ...[SIS Act]. *...* [Further] *... the use of shares owned by the fund, as security over the in-built loan portion of the instalment warrant purchase, amounts to placing a charge over a fund's assets.'*

It seems that the Regulator differentiates between the investment in instalment warrants via a "shareholder application", and one involving issuer application. The Regulator in the Guidelines observed that

> *'... investment in instalment warrants via shareholder application normally involves the charging of a fund asset. ... Accordingly, investment via shareholder application is generally not an appropriate means of implementing any part of the fund's investment strategy and is likely to contravene Regulation 13.14.'*

That is, there seems to be a difference between instalment warrants entered into by a superannuation fund using their existing assets, and those that charge property that has never been held by a superannuation fund. As the underlying property in most warrant arrangement are never held by investor (ie. a superannuation fund), and is not held by the investor / superannuation fund until the warrant transaction is complete, there will typically not be a "shareholder application" of an investor / superannuation fund's existing asset and therefore no charge over a Fund asset.

We note that in the Explanatory Memorandum, there is still a different treatment of 'shareholder applications' to 'cash applications'.

> *'3.17 'Shareholder application' instalment warrants generally involve the use of a fund's existing equity holdings (traditionally, but not limited to, listed shares) to purchase instalment warrants. That is, the fund trustee transfers the legal title of an existing asset to a security trustee in exchange for instalment warrants over that asset. The fund trustee may also receive cash, generally the difference between the price of the warrant and the market price of the asset.*
>
> *3.18 The Commissioner and APRA, in their roles as regulators of superannuation funds, have determined that such an arrangement involves the fund trustee placing a charge over an*

asset of the fund (Joint Press Release of 16 December 2002). The operating standard set out in Regulation 13.14 of the Superannuation Industry (Supervision) Regulations 1994 prohibits a trustee from giving a charge over, or in relation to, an asset of the fund.'

(a) Whether there is a 'proprietary interest' in the underlying property held subject to a warrant arrangement is 'charged'

A typical warrant gives rise to a trust arrangement. As a result, an investor in such a product will not have a proprietary equitable interest in the property which is subject to the warrant relationship – notwithstanding that the investor may have a beneficial interest in the underlying property – although this would normally only be in respect to the surplus of the trust fund, and not in respect of the underlying property.

The High Court in *CPT Custodians Pty Ltd v Commissioner of State Revenue; Commissioner of State Revenue v Karingal 2 Holdings Pty Ltd* [2005] HCA 53 ('**CPT Custodians**') observed that the nature of a trust is dependent upon the terms of the trust deed – with any labels placed on the trust being irrelevant. The Court at paragraph 15 observed that:

*'… a priori assumptions as to the nature of unit trusts under general law and principles of equity would not assist and would be apt to mislead. All depends … upon the terms of the particular trust. The term 'unit trust' is the subject of much exegesis by commentators. However, '**unit trust'**, like 'discretionary trust', in the absence of an applicable statutory definition, **does not have a constant, fixed normative meaning** which can dictate the application to particular facts '.* [emphasis added].

That is, it was essential to determine the precise terms of the relevant trust deed.

In quoting Nettle J, the Court in CPT Custodians observed at paragraph 37 that the unit holders did not have a specific entitlement to receive specific income, but rather:

'… in a case of a complex unit trust of the kind with which I am concerned, the entitlement of the trustee to apply receipts in defined ways informs the nature of the income that the unit holders have a right to receive: not a total of all of the receipts derived from each asset the subject of the fund but rather such if any income as may be derived from the product of the application of gross receipts in various ways.'.

Further, the Court observed that the rights of the unit holders are secondary to the discharge of liabilities that may arise – the only entitlement of the unit holder is a proportionate share of the trust's income (paragraph 37):

*'It may well be that the income of the fund as finally constituted and distributed will include all of the rents and profits generated by a particular parcel of land within the fund. But it is distinctively possible that it will not. Each of the deeds gives power to the trustee to provide out of receipts of any property or business; to invest receipts in authorised investments and to deal with and transpose such investments; and **the only right of the unit holder is to a proportionate share of income of the fund for the year**.'* [emphasis added].

The High Court's decision in CPT Custodians was applied in *Warren Halloran & Ors v Minister Administering National Parks and Wildlife Act 1974* [2006] HCA 3 ('**Halloran's Case**').

In Halloran's Case, land was 'transferred' by a scheme involving a complex series of steps, the result of which was that the original owner became the owner of units in a unit trust owning the land. The scheme relied on the 'transfer' to the trusts not giving rise to a change in beneficial ownership. It was thought that as the original owner held all the units in the unit trust that it was

still the beneficial owner of the land. This view was rejected by the High Court. In referring to the decision of CPT Custodians, the High Court considered that the unit holder in a unit trust has no interest in any particular asset of the unit trust (refer paragraph 75).

As a result, the prohibition against charging contained in Regulation 13.14 of the SIS Regulations should (typically) not be breached by a superannuation fund investing in a warrant product.

Furthermore, given that subsection 67(4A) of the SIS Act has been introduced, arguably any 'charging' implicit in a warrant arrangement is not prohibited as a result of Regulation 13.15 of the SIS Regulations, which provides that '*The standards stated in regulations 13.12, 13.13 and 13.14 do not apply to an assignment or charge that is permitted, expressly or by necessary implication, by the Act or these regulations*'.

14 Superannuation fund trust deeds

The warrant arrangement, or indeed an arrangement established to meet the requirements of subsection 71(4A) of the SIS Act gives rise to a 'borrowing'. Given that a superannuation fund is a trust relationship, it is essential to determine whether the superannuation fund deed allows the trustee to enter into such an arrangement.

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15 Taxpayer Alert TA 2008/5

The Commissioner of Taxation issued Taxpayer Alert TA 2008/5 entitled *Certain borrowings by self-managed superannuation funds* (**'the Alert'**) on 4 April 2008. The Commissioner observes that the '*… Alert is concerned with arrangements under which the trustee of a self managed superannuation fund (SMSF) enters into certain limited-recourse borrowings, which may not meet the conditions in subsection 67(4A) and/or breach other provisions of the Superannuation Industry (Supervision) Act 1993 (SIS Act), as well as related superannuation rules.*'

The Alert points out 6 'features which concern us'. Five of them is identified and discussed in the following passages (the sixth is discussed under the next heading):

(a) Lending at less than commencing rate

The Commissioner's view is that a loan made under a warrant arrangement to a superannuation fund where the interest charged is nil or less than a commercial rate of interest is likely to be characterised as a contribution to the fund. If contributions are excessive then excess non-concessional contribution tax may be payable under Division 292 of the *Income Tax Assessment Act 1997* (Cth) ('**the 1997 Act**'). This will only be an issue when the contributions which have been made are near the limit in any event.

(b) Lending at an interest rate exceeding commercial terms

Lending at an interest rate exceeding a commercial rate may give rise to a breach of the sole purpose test in section 62 of the SIS Act or a breach of paragraph 65(1)(b) of the SIS Act. Paragraph 65(1)(b) prohibits the trustee from giving financial assistance to a member or a relative of a member. Either breach would lead to the fund becoming a non-complying fund.

(c) Capitalisation of interest

The view expressed is that capitalisation of interest may mean that the money borrowed has not been applied for the acquisition of an asset as is required by paragraph 67(4A)(a) of the SIS Act. This paragraph does not say whether the moneys borrowed need to be applied directly or indirectly for the acquisition of the asset. Capitalised interest is applied in an indirect sense to the acquisition of the asset. Doubtlessly the Commissioner would argue that the capitalisation is to maintain the asset by the superannuation fund rather than acquire it. The issue is contentious.

(d) Prohibited assets

The Commissioner reminds us about the specific effect of subparagraph 67(4A)(b)(ii) that requires the asset subject of the arrangement to be one the trustee is not prohibited by the SIS Act or any other law from acquiring. He goes on to add or prohibited from acquiring under the fund's governing rules. This last observation simply means that the rules would need to be amended provided the general prohibition is not breached.

(e) Existing assets

There is also a reminder that assets already owned by a fund cannot be transferred to a trustee and subjected to a borrowing. This restriction is expressed in the terms of subsection 67(4A) which allow a trustee to borrow to acquire an asset. It follows that if the trustee already owns the asset the trustee does not acquire it. The borrowing would not be for the statutory purpose.

16 Guarantees and 'instalment warrant' arrangements

The paragraphs below consider the Commissioner's comments relating to the right of a member or related party of a superannuation fund who provides a guarantee for the purposes of enabling the trustee of the fund to enter into an 'instalment warrant' arrangement complying with subsection 67(4A) of the SIS Act. Notwithstanding the Commissioner's comments in the Alert, a guarantor's rights against the borrower are limited to the rights of the creditor as against the borrower. As a result, if the creditor's rights as against the trustee of a fund which enters a subsection 67(4A) of the SIS Act arrangement are limited in recourse, as the subsection requires, then so too will the guarantor's rights of subrogation as against the trustee in the event that the guarantor seeks redress when the trustee defaults and the guarantee is exercised by the lender.

16.1 Overview of the regulatory regime

The Alert is concerned with the application of subsection 67(4A) of the SIS Act, which provides an exemption from the general prohibition imposed on trustees of superannuation funds with respect to borrowing. The borrowings prohibition is contained in subsection 67(1) of the SIS Act, which provides that: '*Subject to this section, a trustee of a regulated superannuation fund must not … borrow money; or … maintain an existing borrowing of money*'. Subsection 67(4A) of the SIS Act provides that:

> *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.*

Paragraph 67(4A)(d) provides that under the arrangement '*… the rights of the lender against …* [the trustee of the superannuation fund] *… for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited …*' to the asset held subject to the 'instalment warrant' arrangement. That is, although subsection 67(4A) requires a lender's rights as against a trustee of a superannuation fund to be limited in recourse, there is no limitation prohibiting the provision of additional security, outside of the superannuation fund structure, as security for the loan. Indeed, there is no limitation on (for example) a member of the superannuation fund providing a guarantee in favor of the lender with respect to the borrowings by a trustee of a superannuation fund under a subsection 67(4A) arrangement.

At paragraph 6 of the 'Description' section of the Alert, the Commissioner outlines a number of 'concerns' under subsection 67(4A) of the SIS Act arrangements, including that

- the interest rate for the borrowing is zero or less than a commercial rate, particularly where the lender is a related party;
- the interest rate for the borrowing exceeds a commercial rate, particularly where the lender is a related party
- interest on the borrowing is able to be capitalised;
- a personal guarantee for the borrowing is given by a third party, particularly where the guarantee is given by a member or a related party of the SMSF; and
- the asset acquired (or any replacement) is one that a trustee is prohibited from acquiring under the SIS Act or any other law, or under the SMSF's governing rules (for example, acquiring residential property, which is not business real property, from a related party).

This paper concentrates on the Commissioner's views regarding personal guarantees given in order to secure subsection 67(4A) arrangements. Specifically, the Commissioner's concern, which is outlined at paragraph 4 under the 'Features which concern us' section of the Alert, is that:

> *… a personal guarantee of the type outlined in paragraph 6 (d) above may result in recourse being made to the assets of the SMSF other than the asset acquired (or any replacement) in the event that the guarantee is enforced against the trustee as the principal debtor, contrary to the intent that the exception in subsection 67(4A) of the SIS Act only applies to limited recourse borrowings…*

Although the Commissioner does consider that a personal guarantee 'may' result in recourse being made to the assets held within the superannuation fund, it is argued here that the law of surety only allows a guarantor to stand in the shoes of a lender by way of the doctrine of subrogation. That is, to the extent that a lender's rights are limited in recourse as against the trustee of a superannuation fund with respect to specific property, so too will a guarantor's right to indemnification if the guarantor discharges the trustee's obligation under the subsection 67(4A) arrangement.

In 'Instalment warrants and super funds – questions and answers', the Commissioner states that whilst it may have concerns '*… the Tax Office does not yet have a formal view …*' in relation to (amongst other things) arrangements '*… where a borrowing is guaranteed by a third party … particularly where the personal guarantee is provided by a member or a related party …*'.

16.2 A guarantor's right of subrogation

A guarantor is a surety, being a party that answers for the default of another. In the current context, the potential defaulting party is a trustee of a superannuation fund that enters into a subsection 67(4A) arrangement (being a debtor / borrower relationship). As mentioned above, subsection 67(4A) provides that recourse with respect to borrowings by a trustee of a superannuation fund must be limited to the asset purchased subject to the subsection 67(4A) arrangement. The subsection does not limit liability with respect to security given to effect the arrangement, nor does it limit a third party's right to give a guarantee. All that is required is that the liability of the trustee of the superannuation fund be limited.

The relevant surety for current purposes includes an entity that guarantees the superannuation fund trustee's borrowings. A characteristic of a guarantee arrangement is that the guarantee has a right of subrogation. Prima facie, a guarantor under a subsection 67(4A) of the SIS Act arrangement, and discharges a superannuation fund trustee's borrowings (i.e. pays a liability of the trustee which is owed to its creditor) has the right to be subrogated to the right of the creditor, including any securities held by the creditor. Subrogation has been explained as follows:

> *'Subrogation' literally means 'substitution'; the word derives from the same Latin root as the more familiar word 'surrogate'. In English law the term 'subrogation' denotes a process by which one party is deemed to have been substituted for another, so that he can acquire and enforce the other's rights against a third party for his own benefit. It is often said that a subrogation claimant 'stands in the shoes' of the party whose rights he is deemed to have acquired.* [7]

Further:

> *The doctrine of subrogation derives from the English equity of putting one person in the place of another in cases where there are three or more persons involved: where A discharges B's liability in circumstances where B has a right of reimbursement or recoupment in respect of the liability as against C, equity regards A as succeeding to B's right.*[8]

That is, a surety, such as a guarantor, has a right to indemnify itself, via its right of subrogation, in the event that the guarantee is called upon by a creditor and met by the guarantor. Aickin J in *Israel v Foreshore Properties Pty Ltd (in liq)* (1980) 30 ALR 631at 636 observed that:

> *A person who acts on such a request to pay, or who accepts the role of a surety in that manner and who pays the debt, is entitled to an indemnity from those who made the request to pay or to act as surety. … Lord Kenyon CJ in Exall v Partridge* … [*observed* that] *… "I admit that where one person is surety for another, and compellable to pay the whole debt, and he is called upon to pay, it is money to paid to the use of the principal debtor, and may be recovered in an action against him for money paid, even though the surety did not pay the debt by the desire of the principal …"…*

Gibbs ACJ in *Australasian Conference Association Ltd v Mainline Constructions Pty Ltd (in liq)* (1978) 141 CLR 335 made the following observations:

> *… a right of subrogation arises by force of "that equity, upon which it is considered against conscience, that the holder of the securities should use them to the prejudice of the surety; and therefore there is nothing hard in the act of the Court, placing the surety exactly in the*

[7] Mitchell, C and Watterson, S. *Subrogation ñ Law and Practice*. Oxford University Press, Oxford, 2007, p. 3.
[8] Dal Pont, G E and Chalmers, DRC. *Equity and Trusts in Australia.* Lawbook Co, Sydney (4th ed), p. 381.

> *situation of the creditor" … The principal underlying the doctrine is that it would be inevitable for a creditor, by choosing not to resort to remedies in his power, to cast the whole of the obligation on the surety … and it is well settled, a surety who has paid the debt due to the creditor is entitled to stand in the creditor's shoes; he has the creditor's rights, but only those rights.*

Cole AJA in *Austin v Royal* [1999] NSWCA 222 observed that:

> *The theory underlying the equitable concept of subrogation is that a creditor, having no use for a security over his debtor's assets because the creditor's debts have been paid and obligations discharged by the guarantor, is obliged to transfer the security to the guarantor who may then enforce it to recover the moneys from the debtor which he, the guarantor, has paid to the creditor.*

A 'guarantee' is different to an 'indemnity'. Whilst a guarantee is a secondary liability, and is dependent on the primary liability of a debtor, an indemnity is a primary liability, as it is a '*… promise by the promisor that he will keep the promise harmless against loss as a result of entering into a transaction with a third party…*' (*Sunbird Plaza Pty Ltd v Maloney* (1988) 166 CLR 245).

16.3 Right of subrogation is an equitable based right

A guarantor's right of subrogation does not depend on contract, but is a right recognized at equity. Campbell J in *Brueckner v The Satellite Group (Ultimo) Pty Ltd* [2002] NSWSC 378 at para 130 observed that: '*While a creditor who has the benefit of a guarantee is free, if he chooses, to sue the guarantor rather than to sue the principal debtor, if the creditor takes that choice the guarantor will be given a remedy by equity, of subrogation to the rights which the creditor had against the principal debtor.*' Campbell J went on to explain the rationale: '*What is driving equity here is that, while the creditor is free to choose which of the means of recovering his debt he will adopt, his choice ought not determine where the loss ultimately lies, as between the guarantor and the principal debtor. It is for this reason that the surety is entitled, upon payment of the guaranteed debt, to be subrogated to any securities which the creditor had for that payment'.*

Further, Meares J in *Commissioner of State Savings Bank of Victoria v Patrick Intermarine Acceptances Ltd (in liq)* (1977) ACLR 546 at 550 observed that: '*Subrogation is an equitable principle; it does not depend upon principles of contract. Its modern attributes derive from English equity of putting one person in the place of another in cases where there are three or more persons involved …*'.

16.4 A surety's rights are new rights

There are a number of UK authorities which stand for the proposition that a surety such as a guarantor does not acquire a creditor's right as against the debtor. This is because after a guarantee has been called upon, and the debtor's obligations with respect to a creditor has been discharged, then the creditor's rights are extinguished, and therefore can no longer be enforced against the debtor (see *Banque Financiere de la Cite v Parc (Battersea) Ltd* [1999] 1 AC 221).[9] Rather, to the extent that the creditor's right has been extinguished, then the surety acquires

[9] It is noted that *Halsbury*, 4th ed vol 20, p. 126, para 234 was cited in Commissioner of State Savings Bank of Victoria v Patrick Intermarine Acceptances Ltd (in liq) (1977 7 ACLR 546 at 551, where it is observed that ëA *surety who has made payment of more than his due portion of the common liability is entitled to have assigned to him all the creditorís rights and securities, whether satisfied or not, for the purpose of obtaining contribution* Öí [emphasis added]. However, those comments were in the context of co-contributions by sureties.

new rights as against the debtor. (*Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418).[10]

16.5 The scope of the surety's 'new' rights – replication of creditor's rights

Generally, a surety's new right replicates, and does not extend past the rights of the debtor. Evans LJ in *Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418 observes that '*… the rights which are transferred …* [to the claimaint] *… must be those which existed immediately before the discharge took place …*', and that '*… emphasis …* [should be] *… placed on the existing equitable rights of the …* [surety] *… rather than regarding them simply as rights which he has inherited from the …* [creditor] …'. Further, May LJ in *Filby v Mortgage Express (No 2) Ltd* [2004] EWCA Civ 759 held that the '*… essence of the remedy is that the court declares the claimant to have a right having characteristics and content identical to that enjoyed …* [by the creditor] …'.

The following propositions have been made with respect to a surety's right of subrogation:[11]

Number	Proposition
One	The surety's new rights inherit any defects of the creditor's original security interest.[12]
Two	The surety cannot exercise its subrogation rights such that it recovers a larger amount than the creditor could have recovered.[13]
Three	Any security interest that a surety acquires inherits the same priority as the creditor's security interest.[14]
Four	The debtor's liability to the surety may share the same qualities as the discharged liability to the creditor (e.g. a secondary rather than a primary liability, or a deferred rather than immediate liability).[15]
Five	The surety cannot take action to enforce a right which could not have been enforced by the creditor.[16]

Importantly for current purposes, the cases demonstrate that a guarantor inherits the same rights to a security interest that a creditor has. As a result, to the extent that a creditor's rights to security is limited in recourse, then so too will be the guarantor's rights. An example of a similar proposition is explained by Campbell J in *Brueckner v The Satellite Group (Ultimo) Pty Ltd* [2002] NSWSC 378:

[10] It should be noted that the doctrine of subrogation in the UK authorities seems to be based on the equitable principle of unjust enrichment, as provided for in *Banque Financiere de la Cite v Parc (Battersea) Ltd* [1999] 1 AC 221. However, it seems that the Australian courts have not accepted such as basis. For example, Bryson J in *Challenger Managed Investment Ltd v Direct Money Corporation Pty Ltd* (2003) 59 NSWLR 452 observed that the court ëÖ *would respectfully say that Lord Hoffmanís relation Ö of subrogation to unjust enrichment Ö* [in *Banque Financiere de la Cite v Parc (Battersea) Ltd*] *Ö is not established in Australian case law.*í

[11] See: Mitchell, C and Watterson, S. *Subrogation ñ Law and Practice*. Oxford University Press, Oxford, para 8.20 ff.

[12] *Castle Phillips Finance Co Ltd v Piddington* (1995) 70 P & CR 592.

[13] *Cheltenham & Glouster plc v Appleyard* [2004] EWCA Civ 291.

[14] *Drew v Lockett* (1863) 55 ER 196.

[15] *Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418.

[16] *Thurstan v Nottingham Permanent Benefit Building Society* [1902] 1 Ch 1.

> *If the creditor has …* [for example] *… , through neglect, caused a security to be lost or impaired, the value of the guarantor's right of subrogation is correspondingly diminished. In other words, equity's capacity to ensure that the arbitrary choice of the creditor about from whom he seeks recovery, does not decide where the loss ultimately falls, is diminished.*

As a result, Campbell J observed that:

> *There then arises an equity between the creditor and the guarantor – because, as a result of the creditor's neglect, in losing or impairing a security, equity's ability to ensure that the arbitrary choice of the creditor about whom to sue does not decide where the loss ultimately falls has been diminished, equity decides that the ability of the creditor to enforce the guarantee must be correspondingly diminished. When all that is driving equity in this area is ensuring that a guarantor does not suffer in consequence of the arbitrary decision of a creditor about who to sue first, the area of equity's concern, the scope of the purpose which the equitable obligation is aiming to achieve is fully satisfied if a remedy is provided which reduces the guarantor's liability by the value of the security which has been lost.*

That is, if a creditor is limited in recourse, then a guarantor's right of subrogation will similarly be limited.

16.6 Rights of a surety differ from creditor's rights

There are also authorities which illustrate when the rights of a surety may differ from the rights of a creditor:[17]

Number	Proposition
One	The Court may modify a surety's rights where the debtor (or another party) has successfully invoked a defense.[18]
Two	The surety's right to subrogation may differ as compared to the creditor's entitlement due to a third parties priority to (for example) the security interest.[19]
Three	A surety that has a right of subrogation may not inherit a right of a creditor to 'tack' further advances as against the security interest.
Four	The limitation period for both the surety and the creditor may not be the same.
Five	The interest charged by a surety may not be limited to the interest which a creditor could charge.

[17] See: Mitchell, C and Watterson, S. *Subrogation ñ Law and Practice*. Oxford University Press, Oxford, para 8.26 ff.
[18] *Gertsch v Atsas* [1999] NSWSC 898.
[19] *Cheltenham & Glouster plc v Appleyard* [2004] EWCA Civ 291

17 Legislation and surety's

The equitable right of a surety is also found in legislation.[20] As an example, subsection 3(1) of the *Law Reform (Miscellaneous Provisions) Act 1965* (NSW):[21]

> *(1) A person who, being surety for the debt or duty of another, or being liable with another for a debt or duty, pays that debt, or performs that duty, is entitled:*
>
> *(a) to have assigned to that person, or to a trustee for that person, every judgment, specialty or other security held by the creditor in respect of that debt or duty, whether or not that judgment, specialty or other security is taken at law to have been satisfied by the payment of the debt or the performance of the duty, and*
>
> *(b)* ***to stand in the place of the creditor*** *and to use all the remedies, and, if necessary, and on a proper indemnity, to use the name of the creditor in any proceedings to obtain from the principal debtor or any co-surety, co-contractor or co-debtor (as the case requires) indemnity for the advances made and loss sustained by the person who paid the debt or performed the duty.* [emphasis added]

Olsson J in *Johnson v Australian Guarantee Corporation Ltd* (1992) 59 SASR 382 at 389 observed that such provisions are '*… a general remedial provision designed to codify and provide a broad legal framework for the law related to trade and commercial transactions; and to clarify rights of, and relationships between, parties in the absence of an expressed contrary intention'*. Zeeman J in *Bayley v Gibson Ltd* (1993) 1 Tas R 385 at 397 observed that the legislation '*… does not derogate from the equitable right of a surety …*'. Further, it was observed in *Austin v Royal* [1999] NSWSC 222 that the '*… statutory provisions "artificially keeps alive the security" for the benefit of the guarantor…*'.

17.1 Waiving a surety's rights

For completeness, it should be noted that a surety's right as against a debtor may be waived in the following circumstances,[22] including:

- **If, without request or obligation, a person assumes an obligation or makes a payment for another** – as an example, if a person pays off a mortgage without an arrangement as between a mortgagor and mortgagee, then that person will have no right of subrogation with respect to the mortgagor (see for example *State Bank of South Australia v Rothschild Australia Ltd* (1990) 8 ACLC 925 at 940). Fox LJ in *Electricity Supply Nominees Ltd v Thorn EMI Retail Ltd* (1991) 63 P & CR 143 observed that:

  > *If a person makes a voluntary payment intending to discharge another's debt, he will only discharge the debt if he acts with that person's authority or the latter subsequently ratifies the payment. Consequently if the payor makes the payment without authority and does not obtain subsequent ratification he normally has no redress against the debtor.*

[20] Section 13 of the *Mercantile Law Act 1962* (ACT); for the Northern Territory, section 3 of the *Mercantile Law Amendment Act 1861* (SA), and see section 17 of that Act for application in South Australia; section 4 of the *Mercantile Law Act 1867* (Qld); section 13 of the *Mercantile Law Act 1935* (Tas); section 52 of the *Supreme Court Act 1986* (Vic); and for Western Australia, section 5 of the *Mercantile Law Amendment Act 1856* (Imp) (19 & 20 Vict c 97).

[21] Inserted into the *Law Reform (Miscellaneous Provisions) Act 1965* (NSW) by section 5 of the *Usury, Bills of Lading and Written Memoranda (Repeal) Act 1990 No. 7* (NSW)

[22] See: Dal Pont, G E and Chalmers, DRC. *Equity and Trusts in Australia.* Lawbook Co, Sydney (4th ed), para 14.15.

- **If a right of subrogation is inconsistent with a statute** – see for example section 65 and 66 of the *Insurance Contracts Act 1984* (Cth), which respectively deal with subrogation to rights against family, and subrogation to rights against employees. See also *Re Sara Properties Pty Ltd (in liq)* [1982] 2 NSWLR 277 at 279-281.
- **If the right of subrogation is excluded or limited by agreement as between the parties** – see *State Bank of South Australia v Rothschild Australia Ltd* (1990) 8 ACLC 925 at 941.
- **If the right of subrogation is waived, either in whole or in part** – see for example *New Zealand Society of Accountants v ANZ Banking Group (New Zealand) Ltd* [1996] 1 NZLR 283 at 286.

As a result, notwithstanding the limitation of a guarantor's right of subrogation to the rights which a creditor has, in the event that a member or a related party of a superannuation fund gives a guarantee for the purposes of the trustee of the fund to enter a subsection 67(4A) of the SIS Act arrangement, then the guarantor may undertake to waive its rights (if any) to subrogation as against the trustee of the fund.

17.2 Conclusion

Although seemingly formulaic, the Alert provides some examples of complex legal issues that need to be considered in order to both comply with the borrowings carve-out contained in subsection 67(4A) of the SIS Act, and also engineer enforceable legal arrangements.

As with most arrangements which give rise to a borrowing, creditors typically seek to secure amounts lent to the maximum extent possible. In 'instalment warrant' arrangements, security required by creditors will often require members or related parties of the superannuation fund trustees to provide personal guarantees.

As discussed above, as a guarantor is a surety, a guarantor will have a right of subrogation as against a trustee of a superannuation fund who has defaulted with respect to an 'instalment warrant' arrangement. The effect of the right is that once an amount has been paid by the guarantor in satisfaction of the creditor's demands on the trustee as principal debtor, but discharged by the guarantor, then the guarantor may stand in the place of the creditor with respect to recovering amounts as against the trustee. However, given that a complying subsection 67(4A) of the SIS Act arrangement requires a creditor to have its rights limited in recourse to the asset held subject to the instalment warrant arrangement, so will the guarantor's rights be limited in the same way.

In order to ensure beyond doubt that the exposure of trustees is limited in recourse as required by subsection 67(4A) of the SIS Act, the parties to an instalment warrant arrangement (and in particular the guarantor) may waive any rights that the guarantor may have as against a defaulting trustee of a superannuation fund.

18 Taxation implications

18.1 Interest deductions referable to borrowings by the Investor used to acquire the underlying asset held subject to a warrant arrangement.

As discussed above, the Investor borrows in order to acquire the underlying asset held subject to the warrant relationship. Paragraph 67(4A)(a) of the SIS Act provides that there is no prohibition against *'… **a trustee (the RSF trustee) of a regulated superannuation fund from borrowing money**, or maintaining a borrowing of money under an arrangement under which … 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*'. That is, it is the trustee of a superannuation fund that borrows, and therefore incurs interest expenses.

In Product Ruling PR 2004/3, entitled *Income tax: tax consequences of investing in Macquarie Regular Instalment Warrant IMF Series 2003 Product Disclosure Statement – cash applications and on-market purchasers* (withdrawn)[23] ('**PR 2004/3**'), the Commissioner at sub-paragraph 19(a) considered that *'… section 8-1 of the ITAA 1997 will apply to allow an Investor a deduction for the interest charged under the Loan Agreement …*'. The Commissioner at paragraph 21 of PR 2004/3 provided the following explanation:

> *'The cost (or interest paid) of a borrowing used to acquire income producing assets such as shares or units in a trust … [i.e. the assets that are held subject to the 'warrant'] … is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33).'*

In Product Ruling PR 2004/68 entitled *Income tax: consequences of investing in ISG Series UBS Instalment Warrants 2004 Product Disclosure Statement – cash applicants and on-market purchasers* (withdrawn)[24] ('**PR 2004/68**'), the Commissioner at sub-paragraph 17(a) considers that '*… the Interest Amount paid by a Holder under the Loan Agreement is deductible to the Holder under section 8-1 of the ITAA 1997 …*'. The Commissioner at paragraph 19 of PR 2004/68 provided the following explanation:

> *'The interest paid on a borrowing used to acquire income producing assets such as shares and units in a trust is generally treated as deductible under section 8-1 where it is expected that dividends or other assessable income would be derived from the investment (see Taxation Ruling TR 95/33)'.*

Therefore, to the extent that the Investor borrows to acquire the underlying asset (which is held subject to the warrant relationship), and on the basis that the underlying asset is an income producing asset, the Investor will be entitled to a deduction referable to the borrowings.

The prepayment rules will apply in the usual way. Section 82KZL through to section 82KZO of the *Income Tax Assessment Act 1936* (Cth) ('**the 1936 Act**') need to be considered. ATO ID 2003/119 is an example where the prepayment rules did not apply because the underlying assets were listed or widely held securities.

Division 243 of the 1997 Act applies if on the sale of the underlying asset the limitation of recourse is relied upon. Division 243 of the 1997 Act includes in the assessable income of the investor an amount reflecting excessive capital allowances funded by the limited recourse debt. A detailed analysis of these provisions is beyond the scope of this paper. It is enough to put

[23] Paragraph 18 of PR 2004/3 provides that *'The Investors may be individuals, companies, trusts or superannuation funds'*.
[24] Paragraph 16 of PR 2004/68 provides that: *'The Holders may be individuals, companies, trusts or superannuation funds'*.

potential investors on warning that there can be income tax ramifications if the warrant is 'cashed out'.

If the underlying assets are listed shares or units then Division 247 of the 1997 Act potentially has no application. This can treat any excessive funding over and above a benchmark Reserve Bank rate as a put option fee and thus on CGT account. This treatment is illustrated in paragraphs 52 to 55 of Product Ruling PR 2007/73 entitled *Income tax: tax consequences of investing in JP Morgan Dividend Advance Resettable Warrant Instalments Series IQA, IQB May 2007 Product Disclosure Statement – cash applicants and secondary market purchasers* ('**PR 2007/73**').

18.2 CGT events referable to the underlying assets at the Investor level

Generally speaking, the Commissioner considers that when an underlying property is passed from the bare trustee of a warrant relationship to an Investor, then subsection 104-10(7) of the 1997 Act carves out that transfer from CGT event A1. The section provides that *'… CGT event A1 does not happen if the * disposal of the asset was done … to provide or redeem a security …'*.

Paragraph 45 of PR 2004/68:

> *'When the Completion Payment is made, no CGT event will arise in respect of the transfer of the legal title to the Underlying Parcel from the Security Trustee to the Holder by virtue of subsection 104-10(7).'*

That is, the Commissioner is indicating that no CGT event happens within the warrant relationship (i.e. not at the 'Holder' level) when the legal title in the Underlying Securities are transferred to the Holder when the Completion Payment is made. Conversely, the Commissioner at paragraph 46 of PR 2004/68 indicates that the CGT event happens in the hands of the Holder (and not the Security Trustee) with respect to the 'Underlying Parcel':

> *'A CGT event will arise to the Holder if the Holder does not make the Completion payment and the UBS Instalment or the Underlying Parcel is sold to UBS or a third party. The cost base in the Underlying Parcel will be reduced by any excess (if any) of the Loan amount over the market value of the Underlying Parcel in accordance with the provisions of subsection 110-45(3) of the ITAA 1997. The capital proceeds will be the value received by UBS on disposal of the Mortgaged Property.'*

Similarly, the Commissioner at paragraph 51 of Product Ruling PR 2005/96 entitled *Income Tax: tax consequences of investing in ABN AMRO Rolling Instalment Warrants IZY Series 2005 Product Disclosure Statement – Cash Applicants and Secondary market Purchasers* (withdrawn) ('**PR 2005/96**') observed that:

> *'When the Instalment Payment is made, no CGT event will arise in respect of the transfer of the legal title to the Underlying Parcel from the Security Trustee to the Investor by virtue of subsection 104-10(7).'*

However, the Commissioner considers at paragraph 52 of PR 2005/96 that if the Completion Payment is not made and the Underlying Parcel is disposed, then any CGT event will happen for the Investor:

> *'A **CGT event will arise to the Investor if** the Investor does not make the Instalment Payment and the Underlying Parcel is sold to ABN AMRO or a third party. If the sale*

> *proceeds are insufficient to repay the Loan, ABN AMRO has no recourse against the Investor to recover the shortfall. In this circumstance the Investor will need to reduce the cost base of the Underlying Parcel by the amount of the shortfall under subsection 110-45(3).'* [emphasis added]

The same analysis arises in PR 2007/73. The Commissioner observed at paragraph 60 of PR 2007/73 that '*When the Final Instalment payment is made, no CGT event will arise in respect of the transfer of the legal title to the Underlying Parcel from the Security Trustee to the Holder, because of subsection 104-10(7) of the ITAA 1997*'. However, in the event that the 'Final Instalment Payment' is not made, the Commissioner considered at paragraph 61 of PR 2007/73 that:

> *'CGT event A1 will happen if the Holder does not make a Final Instalment Payment on the Expiry Date, a Reset Payment on the Reset Date or payment of a TFN/ABN Amount owing to JPMIAL, and the Underlying Parcel is sold to JPMIAL or to a third party. If the sale proceeds are insufficient to repay the Loan, JPMIAL has no recourse against the Holder to recover the shortfall. In this circumstance the Holder will need to reduce the cost base of the Underlying Parcel by the amount of the shortfall, under subsection 110-45(3) of the ITAA 1997.'*

See also (for example) paragraphs 49 to 51 of PR 2005/89 and paragraphs 51 to 52 of PR 2005/70.

Further, in determining whether the Division 115 of the 1997 Act 50% CGT discount applies, the Commissioner considers that the discount applies to the investor upon the disposal of the underlying property held subject to the warrant, or upon the disposal of the warrant itself. That is, it is the investor, and not the security trustee that avails itself of the Division 115 of the 1997 Act CGT discount. For example, the Commissioner observed at paragraph 63 of PR 2007/73 that:

> *'63. Division 115 of the ITAA 1997 allows a taxpayer a discount on capital gains in certain circumstances. In accordance with section 115-5 of the ITAA 1997,* ***any capital gain realised by a Holder on the sale of an Underlying Parcel*** *received pursuant to the completion of an Instalment will be treated as a discount capital gain where the Holder is an individual, a complying superannuation entity, or a trust and has held the Instalment for at least 12 months.*
>
> *64. In accordance with section 115-25 of the ITAA 1997, the 12 month period for the purposes of the CGT discount will run from the date of acquisition of the Instalment.' [emphasis added]*

Similarly, the Commissioner at paragraph 48 of PR 2004/69 entitled *Income tax: tax consequences of investing in ISH Series UBS Instalment Warrants 2004 Product Disclsoure Statement – cash applicants and on-market purchasers* ('**PR 2004/69**') observed that:

> *'Division 115 allows a taxpayer a discount on capital gains in certain circumstances. In accordance with section 115-5,* ***any capital gain realised by a Holder on the sale of the UBS Instalment or on the sale of an Underlying Parcel*** *received pursuant to the completion of a UBS ISH Instalment will be treated as a discount capital gain where the Holder is an individual, a complying superannuation entity, or a trust and has held the UBS ISH Instalment for at least 12 months.'* [emphasis added]

See also (for example) paragraph 51 of PR 2005/40 and paragraph 51 of PR 2005/41.

That is, the investor (for example a trustee of a superannuation fund) will be considered 'absolutely entitled' to the asset held subject to an instalment warrant arrangement. As a result, any CGT event that happens to the underlying assets will happen at the level of the Investor.

Further, to the extent that the warrant relationship is a bare trust relationship, then CGT event E4 should have no application, as any tax sheltered amounts will be attributed to the Investor directly.

CGT event E5 (section 104-75 of the 1997 Act) applies when a beneficiary becomes absolutely entitled to a CGT asset of a trust. If the Security Trustee arrangement is a bare trust CGT event E5 will have no application because the beneficiary is already absolutely entitled. In this regard section 106-50 of the 1997 Act treats the CGT event as happening to an absolutely entitled beneficiary.

Section 102-25 of the 1997 Act provides a ranking rule for CGT events. If more than one CGT event can happen the one that is most relevant to the situation applies. In this paper it is suggested that the Investor / Security Trustee relationship is (or should be) that of beneficiary and bare trustee. If this is correct then section 106-50 of the 1997 Act applies and the ranking rule has no need to apply. If the ATO's view that the exception to CGT event A1 contained in subsection 104-10(7) of the 1997 Act applies then they must have reasoned that CGT event A1 is the most relevant event.

18.3 Application of Division 6 of the 1936 Act

Notwithstanding that the interest is deductible for the investor, on the basis that the loan is entered into by the investor to acquire the underlying asset held subject to the warrant (and not to invest in the warrant), and that the investor is subject to any CGT event on the disposal of the underlying asset held subject to a warrant arrangement, the Commissioner considers that any income derived from the asset held subject to the warrant arrangement is dealt with under Division 6 of the 1936 Act.

For example, the Commissioner at paragraph 54 of PR 2005/41 considers that:

> *'The Holders are presently entitled to all of the income derived from the Underlying Share. Therefore, section 97 will apply to assess the Holders on the income derived from the Underlying Share. The Security Trustee will not be subject to tax on this income.'*

Paragraph 49 of PR 2004/69:

> *'The Holders are presently entitled to all of the income derived from the Underlying Parcel. Therefore, section 97 will apply to assess the Holder on the income derived from the Underlying Parcel. The Security Trustee will not be subject to tax on this income.'*

See also (for example) paragraph 55 of PR 2005/89 and paragraph 53 of PR 2005/96.

It is submitted that the investor should not be assessed on the 'net income' from a warrant relationship. This is because a warrant is a bare trust relationship, whereas Division 6 of the 1936 Act applies if there is an 'operating' trust relationship.

18.4 Disposal Of Underlying Asset

When the underlying asset is sold to a third party and not acquired by the Investor CGT events A1 happens. If the limitation on recourse is relied upon the ATO takes the view that subsection 110-45(3) of the 1997 Act will reduce the cost base 'to the extent of any amount you have

received as recoupment of expenditure included in the cost base'. This view relies on the definition of 'recoupment' in subsection 20-25(1) of the 1997 Act:

'recoupment of a loss or outgoing includes:

(a) any kind of recoupment, reimbursement, refund, insurance, indemnity or recovery, however described …'.

While this definition is extremely wide it does not, in the writers' opinion quite capture the nature of a limitation on recourse imbedded in the contractual terms of a loan. There is an argument to be had here.

How the potential impact on the cost base interplays with the application of Division 243 will depend on the nature of the asset. If the issue is recouped depreciation then there should be no interplay. However, where the capital allowance is of a different nature, special care needs to be taken. There does not appear to be any specific provision in Division 243 which recognises the potential double taxation (compare with section 243-75 which deals with the interplay of Division 243 and the commercial debt forgiveness rules).

18.5 Goods and services tax implications

Subsection 7-1(1) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) '**the GST Act**' is the central charging provision, which relevantly provides that 'GST is payable on taxable supplies …'. The term 'taxable supply' is defined in section 9-5 of the GST Act as:

'You make a taxable supply if:

(a) you make the supply for consideration; and

(b) the supply is made in the course or furtherance of an enterprise that you carry on; and

(c) the supply is connected with Australia; and

(d) you are registered, or required to be registered.

However, the supply is not a taxable supply to the extent that it is GST-free or input taxed.'

Section 9-70 of the GST Act provides that the *'… amount of GST on a taxable supply is 10% of the value of the taxable supply*'.

That is, in order for GST to apply to a transfer of the property held subject to a Warrant, there needs to be a 'taxable supply' made by the security trustee.

Generally speaking, in the context of in specie transfers of property from discretionary trusts, whether or not the supply is taxable will turn on whether the beneficiary is registered or required to be registered for GST.

(a) Who is 'required to be registered'?

Section 23-5 of the GST Act provides who is 'required to be registered':

*You are **required to be registered** under this Act if:*

*(a) you are * carrying on an * enterprise; and*

*(b) your * GST turnover meets the * registration turnover threshold.*

If the beneficiary is not registered or required to be registered there will be a taxable supply. On the other hand, if the beneficiary is registered or required to be registered and the thing supplied is used solely for a creditable purpose there will be no taxable supply by the trustee (see generally ATO ID's 2001/504 and 505). If the thing supplied is not used solely for a creditable purpose then there will be a taxable supply.

The Commissioner in Goods and Services Tax Advice GSTA TPP 049, entitled *Is a trustee's in-specie distribution to a beneficiary a taxable supply?* considers that an in-specie distribution made to a beneficiary is not subject to GST unless Subdivision 72-A of the GST Act applies:

> *'A distribution made by a trust to a beneficiary does not involve consideration in the form of the surrender to the trust of any rights held by the beneficiary. Therefore, there is no supply for consideration and the supply is not a taxable supply … '.*

Further, the Commissioner in *Edited Version of GST Private Ruling – Authorisation Number: 7248* considered whether the transfer of property between two trusts which merely hold properties and which were both registered for GST, could be considered to be a taxable supply and therefore subject to GST. The Commissioner considered that there was no consideration for a supply when the property was transferred:

> *'The trust deed imposes on Trust B the same duties and responsibilities as were imposed on Trust A. That is, hold their properties upon trust for the congregation, being the same class of persons in each case …. When Trust B performs these duties … it does not do them in connection with, in response to or for the inducement of the supply … the acts of Trust B do not constitute consideration for the supply. Further, Trust B will not be making any payment to Trust A for the supply of the properties.'*

From a policy perspective, the transfer of an asset held subject to a 'bare trust' relationship from a bare trustee to a beneficiary should not be a taxable supply. Indeed, (and for example) in the Property Warrants relationship, it is the Investor that pays the GST for the acquisition / construction of any property held subject to the Warrant, and obtains the input tax credits if the property is commercial residential premises, and not the Security Trustee.

The distribution of the Property is not done *'… in the course or furtherance of an enterprise …'* - being a requirement for a taxable supply in section 9-5 of the GST Act. A trust that is simply an asset holding vehicle does not carry on an enterprise, so that no GST should apply on the vesting of the Property (see ATO ID 2004/712).

(b) Sale of going concern

Moreover, the GST-free sale of going concern exemption may apply to a transfer from the Security Trustee to the Investor. This is desirable as stamp duty is payable by our client on the GST inclusive price.

The GST-free going concern exemption is contained in Subdivision 38-J of the GST Act. Specifically, section 38-325 of the GST Act provides that:

*(1) The * supply of a going concern is **GST-free** if:*

*(a) the supply is for * consideration; and*

*(b) the * recipient is * registered or * required to be registered; and*

(c) the supplier and the recipient have agreed in writing that the supply is of a going concern.

*(2) A **supply of a going concern** is a supply under an arrangement under which:*

*(a) the supplier supplies to the * recipient all of the things that are necessary for the continued operation of an * enterprise; and*

(b) the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as a part of a larger enterprise carried on by the supplier).

That is, in order for a supply of a going concern to be GST-free under section 38-325 of the GST Act:

- the recipient of the supply (i.e. the 'purchaser') must be registered (or required to be registered);
- the supply must be for consideration;
- both parties have agreed in writing that the supply is of a going concern; and
- the vendor must supply all things necessary for the continued operation of the enterprise.

The particular issue that needs to be considered is the application of paragraph 38-325(1)(b) of the GST Act, being that in order for our client to avail itself of the GST-free going concern exemption, the recipient of the supply (being the property subject to a lease) '*... is registered or required to be registered ...*'.

That is, critical is determining who the recipient of the supply is. This is important from both a GST perspective, and also a New South Wales stamp duty perspective - in particular for the purposes of the apparent purchaser concession contained in section 55 of the *Duties Act 1997* (NSW). For current purposes, it will be the 'real purchaser' who will also be the 'recipient' of the supply from a GST perspective.

Example 23 of MT 2006/1 entitled *The New Tax System: the meaning of entity carrying on an enterprise for the purposes of entitlement to an Australian Business Number* gives the following example in which the Commissioner considers that an enterprise is not carried out:

> *'B trust is a holding entity for three companies. The trustee passively holds all shares, is not involved in the running of the companies and provides no services to the group. There are no headquarters of the group but each company provides its own business premises. The trustee for B trust distributes any dividends received to the unit holders. The trustee's activities are not done in the form of a business and it does not carry on an enterprise.'*

The Security Trustee, who holds the legal title of property held subject to a Warrant has a lesser interest than the holding entity described in Example 3. In the Warrant arrangement, it is the Investor and not the Security Trustee that derives income from the asset held subject to the Warrant.

The view that a passive holding vehicle does not carry on an enterprise was confirmed by the European Court of Justice in interpreting the European value added tax provisions in *Polystar*

Investments BV v Inspector der Invoerrecten en Accijzen, Arnhem (Case C-60-90) [1993] BVC 88[25] and *Wellcomne Trust Limited v Commrs of Customs & Excise* [1996] 2 CMLR 909.

This view is supported by the Commissioner at paragraph 64 of the GST Ruling GSTR 2008/3:

> *'* … [i.e. the bare trustee / Security Trustee] *… does not make a taxable supply by transferring legal title to the remaining trust property … to B … [i.e. the beneficiary / Investor in a Warrant arrangement]. This is because the transfer is not made in the course of an enterprise carried on by T in relation to the trust property.'*

Further, because the Security Trustee is not carrying on an enterprise, the Security Trustee will not be registered, or required to be registered for GST. As a result, the transfer of the Property from the Security Trustee to the Investor will not satisfy the requirements of it being a 'taxable supply' contained in paragraph 9-5(a) of the GST Act.

(c) The Commissioner of Taxation's view regarding bare trusts and GST-free sale of going concerns

The GST Ruling considers that the bare trustee will satisfy the requirements of section 38-325 of the GST Act if the bare trustee makes the 'agreement' contemplated in paragraph 38-325(1)(c) of the GST Act. Specifically, paragraphs 82 and 83 of the Ruling provides that:

> *82. For a supply to be GST-free as a supply of a going concern, the supplier and the recipient must agree that the supply is a supply of a going concern.*
>
> *83. In accordance with the principles discussed in this Ruling, a supply or acquisition* ***may be made in the course of an enterprise carried on by the beneficiary****, such that the beneficiary is liable for any GST or entitled to any input tax credit, notwithstanding that title to the relevant property is conveyed by or to a bare trustee for the beneficiary.* ***In those circumstances, if the trustee agrees in writing that the supply is a supply of a going concern, it does so on behalf of the beneficiary. The requirement for the supplier or recipient, as the case may be, to agree to the supply being a supply of a going concern is satisfied in those circumstances.*** [emphasis added]

18.6 Non-application of Subdivision 72-A of the GST Act

Regard needs to be given to Subdivision 72-A of the GST Act. Section 72-1 of the GST Act provides a 'guide' as to the application of Division 72 of the GST Act, and provides that the *'… Division ensures that supplies to, and acquisitions from, your associates without consideration are brought within the GST system, and that supplies to your associates for inadequate consideration are properly valued for GST purposes*'. Subsection 72-5 of the GST Act provides that:

> 'The fact that a supply to your associate is without consideration, does not stop the supply being a taxable supply if:

[25] At paragraph 9, the European Court of Justice was asked to consider ë*Ö whether a holding company whose activities are concerned solely with the holding of shares in subsidiary companies may be classified as a taxable person for purposes of value added tax Öí*. The Court at paragraph 13 held that ë*It does not follow Ö that the mere acquisition and holding of shares in a company is to be regarded as an economic activity Ö conferring on the holder the status of a taxable person. The mere acquisition of financial holdings does not amount to the exploitation of property for the purposes of obtaining income there from on a continuing basis because any dividend yield by that holding is merely the result of ownership of propertyí*. We note that in the Warrant arrangement, the Security Trustee has no right to equivalent of the ëdividend yieldí referred to by the ECJ in *Polystar*.

(a) your associate is not registered or required to be registered; or

(b) your associate acquires the thing supplied otherwise than solely for a creditable purpose'.

The term 'associate' for the purposes of section 72-5 of the GST Act is defined in section 195-1 of the GST Act as having the meaning given to that term in section 318 of the 1936 Act. Relevantly (and amongst other things) an associate of a natural person includes, with respect to:

- natural persons - *'… a trustee of a trust where the primary entity …[i.e. the natural person] …, or another entity that is an associate of the primary entity because of another paragraph of this subsection, benefits under the trust …*' (see paragraph 318(1)(d) of the 1936 Act); and
- trustees – *'… any entity that benefits under the trust …*' (see paragraph 318(3)(a) of the 1936 Act).

That is, the effect of Subdivision 72-A of the GST Act is that a supply to a trust's associate that is without consideration does not prevent the supply from being a taxable supply (and therefore subject to GST) if either:

- the associate is not registered or required to be registered; or
- the associate acquires the supply otherwise than solely for a taxable purpose.

It is the Commissioner's view that whilst Division 72 of the GST Act may apply on a transfer of an asset held subject to a bare trust relationship to a beneficiary, the market value of the supply (being the legal title to the asset held subject to the bare trust) is nil. The Commissioner at paragraph 50 of the GST Ruling observed that:

'We consider that Division 72 (associates) does not apply in these circumstances. That is because, even if the provisions of Division 72 are otherwise satisfied, the market value of the supply is, having regard to the circumstances of the transfer of legal title, nil. In substance, only the bare legal title is transferred. The land remains an asset used in B's enterprise. As the bare legal title is of no economic value, the market value is nil.'

Regard also needs to be given to the characterisation of the asset held subject to the Warrant arrangement. For example, Subdivision 72-A of the GST Act will not apply if the asset is (for example) 'commercial residential premises' when it is transferred from the Security Trustee to the Investor because the Investor will be both registered, and acquiring the Property solely for a taxable purpose.

18.7 Stamp duty

An issue to consider, particularly when the underlying asset held subject to the warrant relationship is 'dutiable property'.

Subsection 11(1)(a) of the Duties Act provides that 'dutiable property' includes *'… land in New South Wales'*. A transfer of the legal title in 'dutiable property' is subject to duty if it is (amongst other things) a *'… transfer of dutiable property …*' (see paragraph 8(1)(a) of the *Duties Act 1997* (NSW) ('**the NSW Duties Act**')).

As a result, and given the requirement to submit a transfer for stamping before the registered proprietor of NSW land can be changed, the stamp duty implications and the documentation required needs to be considered.

However, the apparent purchaser exemption may be available to exempt the charging of ad valorem duty more than once. The following table summarises the applicable provisions in each State or Territory:

State	Stamp duty concession?	Duty payable	Legislation
NSW	YES	Nominal duty of $10	Section 55, *Duties Act 1997 (NSW)*
Victoria	YES	No duty	Section 34, *Duties Act 2000 (VIC)*
ACT	YES	Nominal duty of $20	Section 56, *Duties Act 1999 (ACT)*
Western Australia	YES	Nominal duty	Section 73AA(f), *Stamp Act 1921 (WA*); Section 117, *Duties Act 2008 (WA)*
Tasmania	YES	Nominal duty of $20	Section 39, *Duties Act 2001 (TAS)*
Northern Territory	YES	Exemption is granted as a matter of administrative practice	No specific legislation
Queensland	YES	Ad valorem duty	Note: section 22(3), *Duties Act 2001 (Qld)* may apply concession to agents
South Australia	NO	Ad valorem duty	No specific legislation

(a) New South Wales

Section 55 of the NSW Duties Act provides that:

> *'Duty of $10 is chargeable in respect of:*
>
> *(a) a declaration of trust made by an apparent purchaser in respect of identifiable dutiable property:*
>
> *(i) vested in the apparent purchaser upon trust for the real purchaser who provided the money for the purchase of the dutiable property, or*

(ii) to be vested in the apparent purchaser upon trust for the real purchaser, if the Chief Commissioner is satisfied that the money for the purchase of the dutiable property has been or will be provided by the real purchaser, or

(b) a transfer of dutiable property from an apparent purchaser to the real purchaser if:

(i) the dutiable property is property, or part of property, vested in the apparent purchaser upon trust for the real purchaser, and

(ii) the purchaser provided the money for the purchase of the dutiable property and for any improvements made to the dutiable property after the purchase.'

Subsection 55(1A) of the NSW Duties Act provides that for the purposes of subsection 55(1) of the NSW Duties Act, *'… money provided by a person other than the real purchaser is taken to have been provided by the real purchaser if the Chief Commissioner is satisfied that the money was provided as a loan and has been or will be repaid by the real purchaser*'.

Revenue Ruling No. DUT 30 entitled 'Property Vested in an Apparent Purchaser' also deals with the concession contained in section 55 of the NSW Duties Act.All other States and Territories except Queensland and South Australia provides for similar exemptions.

(b) Victoria

Section 34 *Duties Act 2000 (VIC)* provides:

34 Property vested in an apparent purchaser

(1) No duty is chargeable under this Chapter in respect of—

(a) a declaration of trust made by an apparent purchaser in respect of identified dutiable property or marketable securities referred to in section 10(2)—

(i) vested in the apparent purchaser upon trust for the real purchaser who provided the money for the purchase of the dutiable property or marketable securities; or

(ii) to be vested in the apparent purchaser upon trust for the real purchaser, if the Commissioner is satisfied that the money for the purchase of the dutiable property or marketable securities has been or will be provided by the real purchaser; or

(b) a transfer of dutiable property or marketable securities referred to in section 10(2) from an apparent purchaser to the real purchaser in a case where dutiable property or marketable securities are vested in an apparent purchaser upon trust for the real purchaser who provided the money for the purchase of the dutiable property or marketable securities.

(2) *In this* section, ***purchase*** includes an allotment.

(2A) In this section, a reference to a real purchaser who provided the money for the purchase of the dutiable property includes a person on whose behalf the money for the purchase of the dutiable property was provided.

(3) This section applies whether or not there has been a change in the legal description of the dutiable property or marketable securities.

Example

An example of a change in the legal description of dutiable property is the issuing of new certificates of title of land following a subdivision of the land.

(c) Australian Capital Territory

Section 56 *Duties Act 1999 (ACT)* provides:

56 Property vested in apparent purchaser

(1) Duty of $20 is chargeable in respect of—

(a) a declaration of trust made by an apparent purchaser in respect of identified dutiable property—

(i) vested in the apparent purchaser on trust for the real purchaser who provided the money for the purchase of the dutiable property; or

(ii) to be vested in the apparent purchaser on trust for the real purchaser, if the commissioner is satisfied that the money for the purchase of the dutiable property has been or will be provided by the real purchaser; or

(b) a transfer of dutiable property from an apparent purchaser to the real purchaser if dutiable property is vested in an apparent purchaser on trust for the real purchaser who provided the money for the purchase of the dutiable property.

(2) In this section:

***purchase** includes an allotment.*

(d) Western Australia

Nominal duty is charged on a conveyance or transfer under which no beneficial interest passes in the property conveyed or transferred, not being a conveyance or transfer which, in the opinion of the authority, is made in contemplation of the passing of a beneficial interest in that property or is part of or is made pursuant to a scheme, whereby any beneficial interest in that property whether vested or contingent, has passed or will or may pass to any person: Section 73AA(1)(f), *Stamp Act 1921 (WA)*.

Section 117 of the *Duties Act 2008 (WA)* provides:

117. Property vested in an apparent purchaser

(1) Nominal duty is chargeable on —

(a) a declaration of trust made by an apparent purchaser in respect of identified dutiable property —

(i) vested in the apparent purchaser upon trust for the real purchaser that provided the money for the purchase of the dutiable property; or

(ii) to be vested in the apparent purchaser upon trust for the real purchaser if the Commissioner is satisfied that when liability for duty arose in respect of the transfer, or agreement for the transfer of, the dutiable property, the money for the purchase of the dutiable property was or was to be provided by the real purchaser; or

(b) a transfer of dutiable property from an apparent purchaser to the real purchaser if —

(i) the dutiable property is property, or part of property, vested in the apparent purchaser upon trust for the real purchaser; and

(ii) the Commissioner is satisfied that, when liability 25 for duty on the transaction arose, the money for the purchase of the dutiable property and for any improvements made to the dutiable property after the purchase has been or will be provided by the real purchaser.

(2) For the purposes of subsection (1), money provided by a person other than the real purchaser is taken to have been provided by the real purchaser if the Commissioner is satisfied that the money was provided as a loan and has been or will be repaid by the real purchaser.

(3) This section applies whether or not there has been a change in the legal description of the dutiable property between the purchase of the property by the apparent purchaser and the transfer to the real purchaser.

Note: For example, a change in the legal description of dutiable property in the issuing of a new certificate of title following a subdivision of land.

Relevant Rulings:

- Commissioner's Practice SD 3.0
- Commissioner's Practice SD 28.0.

(e) Tasmania

Section 39 *Duties Act 2001 (TAS)* provides:

39. Property vested in an apparent purchaser

(1) Duty of $20 is chargeable in respect of –

(a) a declaration of trust made by an apparent purchaser in respect of identified dutiable property –

(i) vested in the apparent purchaser upon trust for the real purchaser who provided the money for the purchase of the dutiable property; or

(ii) to be vested in the apparent purchaser upon trust for the real purchaser, if the Commissioner is satisfied that the money for the purchase of the dutiable property has been or will be provided by the real purchaser; or

(b) a transfer of dutiable property from an apparent purchaser to the real purchaser, in a case where dutiable property is vested in an apparent purchaser upon trust for the real purchaser who provided the money for the purchase of the dutiable property.

(2) In this section,

***'purchase'** includes an allotment.*

(f) Northern Territory

There is no specific legislation but as a matter of administrative practice an exemption from conveyance duty is granted where there is evidence that there was an intention to create a trust and that the purchase money was provided by the beneficiary.

The practice of the authority appears to be to require satisfactory evidence that at the time of acquisition of the property the transferor was acting in a trustee capacity. To this extent, it must be shown that the purchase moneys were withdrawn from a bank account in the purchaser's name or else satisfactory evidence of whatever other means must be produced to evidence the provision of the purchase moneys.

(g) Queensland

Ad valorem duty is payable upon any transfer as there is no comparable concessional provision. However section 22(3) of the Duties Act 2001 (Qld) provides where a person is appointed as an agent to purchase an asset which is a dutiable transaction, with all funds for the purchase being made available by the principal then any subsequent transfer of that asset to the principal would not attract stamp duty.

(h) South Australia

Ad valorem duty is payable upon any transfer as there is no comparable concessional provision.

However, it would appear that the practice of the authority is that where it is substantiated to the satisfaction of the authority that one person holds property pursuant to a resulting trust, the authority would not seek to assess ad valorem conveyance rates in respect of both the declaration of trust and a conveyance pursuant thereto.

As a result, in order for only one set of ad valorem duty to be charged on the purchase of underlying property that is 'dutiable property', it needs to be ensured that the documentation surrounding a warrant arrangement complies with the apparent purchaser exemptions under the various Duties Act.

19 Accounting treatment

Mention is made only of what appears to be the appropriate accounting treatment for the warrant.

There is no exposure to the ultimate liability because of the limitation on recourse. Accordingly, the net value of the investment should appear in the Balance Sheet. Interest expenses and borrowing costs would be appropriately amortised.

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