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IT'S ESSENTIAL

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RECENT DEVELOPMENTS
Gearing in Superannuation

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1 BACKGROUND

1.1 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]

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

1.3 Indeed, the Regulator had issued guidelines as to what constitutes a borrowing for the purposes of section 67 of the *Superannuation Industry (Supervision) Act 1993* (Cth) ('**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.'*

1.4 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]

1.5 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*:

> *'… 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]

2 THE PROHIBITION AGAINST BORROWING

2.1 Notwithstanding the change in the Government's view as announced in the Press Release, the *Tax Laws Amendment (2007 Measures No 4) Bill 2007* (Cth) ('**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:

> *'Subject to this section, a trustee of a regulated superannuation fund must not*
>
> *(a) borrow money; or*

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

(b) maintain an existing borrowing of money.'

2.2 Paragraph 5 of the Borrowings Circular observes that '*Under section 67, regulated superannuation funds are generally prohibited from borrowing or maintaining an existing borrowing of money*'.

2.3 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.'

2.4 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.'*

2.5 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.

2.6 That is:

2.6.1 The trustee of the superannuation fund borrows to acquire the underlying asset;

2.6.2 The trustee of the superannuation fund needs to have the 'beneficial interest' in the underlying asset;

2.6.3 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');

2.6.4 The trustee of the superannuation fund has an option to acquire the underlying asset after paying the loan amount;

2.6.5 The lenders rights with respect to the borrowing are limited in recourse, to the underlying asset;

2.6.6 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.

3 RECENT ANNOUNCEMENTS

3.1 On 10 March 2010 the Federal Government made two announcements regarding instalment warrants generally. The announcements relate to the same proposed change to the income tax legislation, complemented each other and should be considered together.

3.2 The Assistant Treasury, Senator Nick Sherry, announced[2] that the income tax legislation will be amended '*to confirm the practice of treating the investor in an instalment warrant over a single exchange traded security in a company, trust or stapled entity as the owner of the listed security for income tax purposes.*' The proposed amendment, which is not limited to superannuation funds, basically confirms that there is no capital gains taxing point at the time the last instalment under the warrant is paid.

[2] Media Release NO.037

3.3 On the same day the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, announced[3] the change referred to by Senator Sherry but highlighted the impact the proposed change will have on superannuation funds. After the amendments '*a superannuation trustee who enters into a limited recourse borrowing arrangement to purchase an asset, as permitted under subsection 67(4A) of the SIS Act, will be treated as the owner of the asset for income tax purposes.*' Basically, when the last instalment under an authorised warrant is paid the asset can be transferred to the superannuation fund trustee without triggering capital gains tax.

(a) The Changes

3.4 The Government has released the '*Income Tax Treatment of Instalment Warrants – Proposals Paper*' in March 2010 ('**the Proposals Paper**'). The Proposals Paper makes clear that the Government will create a 'look through' approach to instalment warrants to treat:

3.4.1 the owner of an instalment warrant over an exchange traded security as the owner of the security; and

3.4.2 a superannuation trustee (i.e., the '**Investor**') who enters into a limited recourse borrowing arrangement for the purpose of purchasing an asset, as permitted under subsection 67(4A) of the SIS Act, as the owner of the asset.

3.5 Broadly, the changes of the 'look through' approach are that:

3.5.1 the Investor will be assessed on any income earned on the underlying asset, such as rental income;

3.5.2 the Investor will be able to claim any relevant deductions, such as capital allowances for the decline in value of property. Where relevant, the investor will also have to adjust the underlying asset's cost base;

3.5.3 if the underlying asset is a depreciating asset, there will be no balancing adjustment when the trustee transfers it to the Investor.

(b) Restrictions on Warrants

3.6 Although not entirely clear from the Proposals Paper, it seems that the changes include as a condition for accessing the 'look through' approach that there are no guarantees provided by members of the fund (or any associate of the fund). The 'no other guarantee' requirement is clearly set out as a condition of the 'traditional instalment warrants'. The superannuation instalment warrants are not expressly subject to this condition, but they are required to be a 'non-recourse borrowing arrangement'. This seems to incorporate the 'no other guarantee' requirement. The ATO have also been attacking the use of guarantee before the proposed changes have effect.

3.7 The significance of this restriction is that lending institutions, unable to seek security from sources outside of the superannuation fund, may reduce the loan-to-value ratios on which they are willing to lend. Clarity on this point is required; the amending legislation should be reviewed to ascertain whether guarantees will be permitted.

(c) Timing of the Changes

3.8 The proposed change is the subject of consultation by the Government with various stakeholders but, when enacted, will apply from the 2007-08 financial year.

3.9 It is also worth noting that Minister Bowen said '*The Government is also aware of some areas of uncertainty with borrowing arrangements made under the SIS Act and is considering the issues involved.*' The Government is currently consulting on these 'areas'.

[3] Media release NO.020

4 CHARGING PROHIBITION – REGULATION 13.14 OF THE SIS ACT

4.1 A common scenario that arises is whether a transfer of an interest in real property (**'the Land'**), of which a trustee of a superannuation fund may already have an interest in, is a permitted acquisition by a trustee of a superannuation fund.

4.2 For example, a situation where the Land is held by two individuals (**'Individuals'**) and a trustee of a self managed superannuation fund (**'the Fund'**) as tenants in common in equal shares. The Fund may intend to acquire the Individuals' interest in the Land (**'the Individual's Interest'**).

(a) Prohibition against a superannuation fund from charging an asset

4.3 An issue that may arise in an instalment warrant arrangement is whether the Fund (or indeed the Security Trustee on behalf of the Funds) may grant third party security in support of a loan where the Investor (i.e. the Fund) is not the borrower. In particular, whether such a scenario complies with regulation 13.14 of the *Superannuation Industry (Supervision) Regulations 1993* (Cth) (**'the SIS Regulations'**).

4.4 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 regulations may prescribe standards applicable to the operation of regulated superannuation funds (**the Fund**) and to trustees and RSE licensees of those funds*.' One such 'operating standard' is contained in regulation 13.14 of the SIS Regulations, which provides that:

> *'For the purposes of subsections 31(1)... of the Act, it is a standard applicable to the operation of regulated superannuation funds ... that, subject to regulations 13.15 and 13.15A, the trustee of a fund must not give a charge over, or in relation to, an asset of the fund.'*

4.5 That is, regulation 13.14 of the SIS Regulations provides that the Fund '*... must not give a charge over, or in relation to, an asset of the fund*'. The Fund will breach regulation 13.14 of the SIS Regulations if it charges (for example) the interest that it has in the Land before it acquires the Individual's Interest (**'the Fund's Interest'**).

4.6 The exceptions to the application to regulation 13.14 of the SIS Regulations are contained in regulations 13.15 and 13.15A of the SIS Regulations. Regulation 13.15 of the SIS Regulations 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.'*

4.7 Regulation 13.15A of the SIS Regulations deals with charges relating to certain derivative contracts.

4.8 That is, to the extent that the SIS Act or SIS Regulations allow a regulated superannuation fund to charge an asset of the fund, then the prohibition contained in regulation 13.14 of the SIS Regulations will not apply.

4.9 Subsection 67(4A) of the SIS Act allows a trustee of a regulated superannuation fund to charge an asset. Further, subsection 67(4A) of the SIS Act does not provide any guidance or limitations with respect to whom the charge may be granted. The provision does not provide that the charge of the underlying asset must only be granted in favour of the 'lender'. Rather, paragraph 67(4A)(d) of the SIS Act requires only that 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...*'. [emphasis added]

4.10 That is, paragraph 67(4A)(1)(d) of the SIS Act uses the term '*... charges related to the borrowing...*'. The provision requires a nexus as between the granting of a charge, and a borrowing. The term 'related' is defined in subsection 10(1) of the SIS Act, and refers to section 20 of the SIS Act. Section 20 of the SIS Act in turn provides the definition of 'related', but does so in the context of related bodies corporate, and refers to the definition of that term in the *Corporations Act 2001* (Cth) ('**the Corporations Act**').

4.11 Because the term 'related to' is not defined in the SIS Act, regard should be given to the ordinary use of that term to determine its meaning in the context of paragraph 67(4A)(d) of the SIS Act. It was observed in *IBM Australia Ltd v National Distribution Services Ltd* (1991) 100 ALR 361 that:

> *'The phrases "in relation to" or "related to" are of the widest import and should not, in the absence of compelling reasons to the contrary, be read down: Fountain v Alexander (1982) 150 CLR 615 at 629; 40 ALR 441; Dowell Australia Ltd v Triden Contractors Pty Ltd [1982] 1 NSWLR 508 at 511, and Ashville Investments Ltd v Elmer Contractors Ltd [1989] 1 QB at 509.'*

4.12 Further, the Court in *Stateside Credit Corporation Pty Ltd v Hudson* [1989] VR 519 considered that:

> *'The expression "relating to" has wide connotation, embracing not only "of" and "over" but also "concerning", "touching" and "about": State of Victoria v Commonwealth of Australia (1971) 122 CLR 353, at 399, per Windeyer J McGarvie J in Ansett Transport Industries (Operations) Pty Ltd v Comptroller of Stamps[1983] 2 VR 305, at 307 commented that it is possible to demonstrate that in one way or another most things are related to other things. However, the meaning to be attributed to the expression depends upon the context in which it appears as well as like expressions appearing in the Credit Act, and the absence of similar expressions in other statutes concerned with mortgages and mortgage securities. While the observations and comments which we make, taken seriatim, may not be conclusive of the appropriate meaning, when considered together they give rise to what we consider to be the proper construction to be given to the expression.'*

4.13 On the basis that the term 'relating to' should be given a wide interpretation, and because the terms of subsection 67(4A) of the SIS Act does not contain that expression, it is submitted that a charge given with respect to the underlying asset to a third party is 'related to' the borrowings of the Investor from the lender. That is, in order for the lender to arrange the borrowings to the Investor, the lender may need to seek finance from a third party which is on-lent to an investor. The charge granted in favour of a third party over the underlying asset is 'related to' the borrowings of the Investor.

4.14 It should also be noted that the term 'lender' is not defined in section 67(4A) of the SIS Act. Therefore, if the third party knows where and how the lent money will be used, on one interpretation the third party may be considered a 'lender' for the purposes of subsection 67(4A) of the SIS Act.

4.15 Further, subsection 67(4A) of the SIS Act does not require (if the borrowings are secured) for the security to be given in directly in favour of the lender. That is, subsection 67(4A) of the SIS Act does not require the security to be necessarily given to the lender. All that the provision requires is that any rights of the lender are limited in recourse to the lender. Further, there is no prohibition or limitation against the lender contracting out its rights under subsection 67(4A) of the SIS Act to a third party.

4.16 That is, consideration needs to be given as to whether the Fund will breach regulation 13.14 of the SIS Regulations if it borrows to acquire the Individual's Interest. Relevant in the analysis is determining the nature of the Individual's Interest which the Fund will obtain upon acquisition – which is essentially a property law question. The specific issue to consider is whether the Fund, by acquiring the Individual's Interest pursuant to a subsection 64(4A) of the SIS Act arrangement, may breach regulation 13.14 of the SIS Act if it charges the Individual's Interest when it is acquired by the Fund.

4.17 As the Fund and the Individuals are tenants in common, they are co-owners of the Land.[4] The fundamental feature of co-ownership relationships is the joint right of each co-owner to possess the property (i.e. the Land). That is, both the Individual's and the Fund have 'unity of possession' with respect to the Land, being that they are both entitled to the non-exclusive possession of the whole of the Land. That is, the whole of the Land is to be enjoyed by both the Individuals and the Fund.

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[4] There are two fundamental types of co-ownership, being 'tenancy in common' and 'joint tenancy'. There are other miscellaneous forms of co-ownership, such as 'coparcenary'. A joint tenancy can only exist if the 'four unities' exist, being (1) 'unity of possession', which exists if all co-owners are entitled to possess the land; (2) 'unity of interest', being that the interest of each joint tenant must be identical in nature, extent and duration; (3) 'unity of title', being that all of the parties must derive their interests from the same title, the same document or the same act for there to be a joint tenancy; and (4) 'unity of time', being that a joint tenancy exists only where the interests of joint tenants have vested at exactly at the same time and under the same instrument. The only 'unity' essential for a tenancy in common is unity of possession.

4.18 As the Individuals and the Fund are tenants in common with respect to the Land, they each hold a distinct, yet undivided share of the Land. Whilst they are both co-owners (as tenants in common) they are able to deal with their undivided shares in the Land as they wish. As an example, a tenant in common (say the Individual's) may encumber its undivided share in the Land (i.e. the Individual's Interest), provided that it does not interfere with the rights of the Fund, the remaining tenant in common. Harris J in *Hedley v Roberts* [1977] VR 282 considered that:

> *'... a joint tenant, or a tenant in common, can encumber his interest in the land so as to compel his co-owner to submit to the encumbrance if the encumbrance does not interfere with the right of that co-owner ... to possession of the land and his other rights with respect to the land.'*

4.19 The Regulator[5] acknowledges that there is nothing to legally prevent the parties to a tenant in common arrangement from allowing a charge to be present over their holding. However, at paragraph 61 of Superannuation Circular No II.D.6 entitled *In-house assets*, the Regulator considers that trustees of superannuation funds should refrain from investing where the other party intends to use its' investment in the property as security against borrowings:

> *'… a fund …*[can] *… invest in property with a related party on a tenants in common basis without the investment being classed as an in-house asset. While the borrowing restrictions prevent a fund from charging assets, the prohibition does not extend to the other titleholders. In APRA's view, it would be more prudent for a trustee to refrain from investing as a tenant in common where the related party intends to use its investment in the property as security against borrowings.'*

(b) Merging of interests when the Fund acquires the Individual's Interest

4.20 An issue to consider is what occurs to the co-ownership (i.e. the tenancy in common relationship) with respect to the Land when the Individual's Interest is transferred to the Fund. If this was to occur, then the tenancy in common would be terminated, as the title to the Land would vest in possession of the Fund. That is, upon termination of a tenancy in common there is no longer be co-owners of the Land (i.e. both the Individual's and the Fund), but only one owner (i.e. the Fund).

4.21 That is, upon the transfer of the Individual's interests in the Land to the Fund, the title to the Land would vest in possession in the Fund. There would no longer be a co-ownership (i.e. there would no longer be a tenancy in common). The Fund cannot be a tenant in common (or a joint tenant) with itself.

(c) The effect of subsection 67(4A) of the SIS Act – different registered proprietors of the Land

4.22 However, paragraph 67(4A)(b) of the SIS Act requires that the interest in the Land held by the Individuals which is transferred to the Fund must be '*... held on trust so that the ...* [Fund] *... acquires a beneficial interest in ...*' the Land being acquired by the Fund. Further, paragraph 67(4A)(c) of the SIS Act implies that when a trustee of a superannuation fund borrows under a subsection 67(4A) of the SIS Act arrangement, the 'legal ownership' (i.e. legal estate) of the asset which is being acquired under the borrowing arrangement is held by an entity other than the trustee of the superannuation fund (i.e. a custodian / bare trustee / security trustee), and that the 'legal ownership' is held by the other entity after the trustee of the superannuation fund acquires the 'beneficial interest' in the asset which the borrowings were used to acquire.

4.23 That is, upon acquiring the Individual's Interest, the Fund's Interest will merge with the Individual's Interest. Furthermore, if the Fund charged the Individual's Interest when it acquires that interest, that charge would merge into the Fund's Interest. This would cause the Fund to breach regulation 13.14 of the SIS Regulations. That is, when the Fund acquires the Individual's Interest, as there will be no other co-owner of the Land, the Individual's Interest will merge with the Fund's Interest, with the result that any charge that the Fund grants over the Individual's Interest will encroach upon the Fund (i.e. it is not possible to mortgage half a property owned by one entity). The result would be that an asset of the Fund would be charged.[6]

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[5] Being both the Australian Prudential Regulation Authority and the Commissioner of Taxation.

[6] Indeed, such a transaction would constitute a 'shareholder application' as opposed to a 'cash application', which would cause Regulation 13.14 of the SIS Regulations to be breached (see the *Guidelines on Instalment Warrants for Superannuation Trustees*).

4.24 However, as noted at **paragraph 4.22** above, the trustee of the Fund will not have the 'legal ownership' (i.e. will not be the registered proprietor) of the Individual's Interest if the Fund borrows to acquire the Individual's Interest pursuant to subsection 67(4A) of the SIS Act. As a result, after the Fund acquires the Individual's Interest under a subsection 67(4A) of the SIS Act arrangement, the legal title of the Land will be held by both the trustee of the Fund and the bare trustee / security trustee under the subsection 67(4A) of the SIS Act arrangement as the registered proprietors of the Land, as tenants in common in equal shares. This is notwithstanding that the Fund will have a 'beneficial interest' in the Individual's Interest.

4.25 Subsection 82(1) of the *Real Property Act 1900* (NSW) (**'the Real Property Act'**) provides that the New South Wales land titles register will prima facie not have any trust relationship recorded. It should be noted that subsection 82(1) is subject to paragraph 12(1)(f) of the Real Property Act, which allows the Registrar-General to record interests in land for the protection of persons. Further, subsection 82(2) of the Real Property Act allows for the lodging (but not registration) of an instrument which evidences a trust over land, and subsection 82(3) of the Real Property Act requires the Registrar-General to record a caveat on land to which an instrument evidencing a trust pursuant to subsection 82(2) of the Real Property Act has been lodged, with such a caveat '*...forbidding the registration of any instrument not in accordance with the trusts and provisions therein declared and contained so far as concerns the land affected by such instrument*'.

4.26 Upon the Fund acquiring the Individual's Interest pursuant to a subsection 67(4A) of the SIS Act arrangement, then the equitable interests in the Land (i.e. both the Fund's Interest and the Individual's Interest) will merge. As a result, in equity, any charge granted by the Fund to acquire the Individual's Interest will include a charge over the whole of the Land (i.e. both the Individual's Interest being acquired, and the Fund's Interest which is already owned by the Fund).

4.27 However, upon the acquisition of the Individual's Interest by the Fund pursuant to subsection 67(4A) of the SIS Act, the legal title of the Land will show the trustee of the Fund, as well as the bare trustee pursuant to the subsection 67(4A) of the SIS Act as the co-owners of the Land. As a result, legally, any charge granted with respect to the Individual's Interest will be attributed to the Individual's Interest, and not also the Fund's Interest. As a result, legally (and putting the equitable interests aside), a charge granted for the purposes of the Fund acquiring the Individual's Interest will not affect the Fund's Interest and therefore will not cause a breach of regulation 13.14 of the SIS Regulations.

4.28 That is, upon the Fund acquiring the Individual's Interest, it will own the whole of the equitable estate in the Land, but will hold half of the legal estate as a tenant in common in equal shares.

4.29 As discussed at **paragraph 4.17** above, a tenant in common has a right to possess the whole of the property, and each tenant is able to deal with their undivided shares in the property as they wish. As an example, a tenant in common may encumber its interest in the Land. As a result, and analogous to a fund that owns land as a tenant in common with another entity that encumbers it's interest in land, by charging the legal estate in the Individual's Interest, the Fund will not charge its interest in the Fund's Interest.

4.30 Indeed, the better view is that because the respective interests in the Land will be clearly defined at law (i.e. pursuant to the legal ownership via the co-ownership), a charging of the Individual's Interest by the Fund will not cause a breach of regulation 13.14 of the SIS Regulations with respect to the Fund's Interest.

4.31 However, there is a possibility that the Commissioner may consider that there will be a charge with respect to the whole interest in the equitable estate of the Land. Indeed, this may be the case if the subsection 67(4A) of the SIS Act arrangement is a bare trust arrangement, with any charges on the Individual's Interest effected via a direction to the bare trustee / security trustee by the Fund. As a result, an issue to consider is whether the Fund does in fact need to charge the asset that it is acquiring pursuant to subsection 67(4A) of the SIS Act.

(d) Whether subsection 67(4A) of the SIS Act requires a charge to be given over the asset being acquired

4.32 Relevantly, paragraph 67(4A)(d) of the SIS Act provides that (and amongst other things) in order for a borrowing of the Fund to comply with subsection 67(4A) of the SIS Act '*... the rights of the lender against the RSF Trustee ...* [i.e. the trustee of the Fund] *... for default on the borrowing, or on the sum of the borrowing or charges related to the borrowing, are limited to rights relating to the original asset ...* [i.e. the interest in the Land acquired from the Individual's] ...'. It should be noted that subsection 67(4A) of the SIS Act requires for the rights of the lender be limited specifically to recourse to the interest being acquired by using the borrowed funds.

4.33 Arguably, a loan under which a lender has no recourse to any of the assets of the superannuation fund which is borrowing to acquire the asset may satisfy subsection 67(4A) of the SIS Act. The requirement of paragraph 67(4A)(d) of the SIS Act is that the rights of the lender are limited in recourse to the assets which are acquired by the borrowings. If the lender has no rights whatsoever (i.e. an unsecured loan), then paragraph 67(4A)(d) of the SIS Act will probably be satisfied.

4.34 As a result, in order to ensure that the Fund does not breach regulation 13.14 of the SIS Regulations, the Fund should not provide a charge (either at law or in equity) over the Individual's. Indeed, documentation should be drafted to ensure that the loan that the Fund obtains for the purposes of acquiring the Individual's Interest includes no security interest whatsoever in the Individual's Interest, or the Land. Of course, such a scenario would probably not be achievable with the third party financier.

4.35 Rather, the loan should be a 'negative pledge'. That is, a form of unsecured lending where the lender relies entirely on contractual terms to protect its position against the borrower and other creditors of the borrower, rather than relying on an interest in the assets of the borrower by way of security.[7]

4.36 If the 'negative pledge' (i.e. an unsecured loan) approach is taken, a further issue that will need to be considered is the rate of interest that should be charged by the lender for such finance.[8] Particularly because the Fund is lending from a related party, and in the context of the Commissioner's views on charging interest (both at excess and under commercial rates) as expressed in Taxpayer Alert TA 2008/5 entitled *Certain borrowings by self-managed superannuation funds* ('**TA 2008/5**').

4.37 However, in the event that there is no charge whatsoever over any asset of the Fund when it acquires the Individual's Interest, then regard should be given to the exposure of the Fund's assets if (for example) a trustee in bankruptcy or (amongst other things) a liquidator is appointed with respect to the lender.

4.38 For example, section 120 of the *Bankruptcy Act 1966* (Cth) (**'the Bankruptcy Act'**) treats transfers of property (which includes the provisions of a loan) by a bankrupt (e.g. possibly the lender) as void as against the trustee in bankruptcy if the '*... transferee ...* [i.e. the Fund] *... gave no consideration for the transfer or gave consideration of less value than the market value of the property.*' The consideration for the loan for the purposes of section 120 of the Bankruptcy Act would include the promise to repay, as well as the payment of interest. An unsecured loan would have a higher than normal rate of interest. The higher rate of interest would be of concern to the Commissioner as outlined in TA 2008/5 (see **paragraph 4.36** above).

4.39 If section 120 of the Bankruptcy Act is satisfied, then the trustee in bankruptcy would be able to claw-back the loan, which may expose the assets of the Fund to the trustee in bankruptcy. Such an outcome is exactly what subsection 67(4A) of the SIS Act is attempting to prevent.

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[7] There are various forms of 'negative pledges'. Typically, a negative pledge takes the form of an undertaking by the borrower that it will not create or allow to exist any security for the payment of money or performance of obligations on the whole or any part of its present or future property, except for agreed exceptions. Such a pledge would need to be considered in the context of the prudential restrictions which superannuation funds are subject to.

[8] Other considerations which typically need to be given in such situations include whether the transaction is appropriate for the Fund (e.g. whether it is a prudent investment and is within the scope of the fund's investment strategy). I also note that the Land is business real property, and therefore may be acquired by the Fund from a related party. Regard also needs to be given to the product switching provisions (and the financial advice provisions generally) contained in the Corporations Act.

4.40 As a result, whilst the borrowings by the Fund should be unsecured so as to ensure that the Fund does not (in equity) breach regulation 13.14 of the SIS Regulations, there is a danger that a third party may be able to attack the assets of the Fund (other than the Individual's Interest) in the event that the lender becomes insolvent. Further, the rate of interest which would need to be charged to the Fund under an unsecured loan would be higher than normal rates, which would need to be considered in the context of the Fund's investment strategy, and the Commissioner's views in TA 2008/5.

4.41 The better (and more prudent) approach would be to establish a new superannuation fund, which would borrow to acquire the Individual's Interest (or indeed the whole of the Land from both the Individual's and the Fund – subject to the tax implications of doing so). The new fund would charge the Individual's Interest upon acquisition. However, regard would need to be given as to whether the Fund should continue to hold its interest in the Fund's Interest if the Individual's Interest is subject to a charge (see discussion at **paragraph 4.19** above).

5 SUPERANNUATION GEARING ON DEATH OF A MEMBER

5.1 Paragraph 52(2)(c) of the SIS Act requires trustees to act in the best interests of the members of a fund and paragraph 52(2)(f) of the SIS Act requires trustees to formulate and give effect to an overall investment strategy for a fund. A superannuation fund trustee should, therefore, be undertaking an instalment warrant investment in the most advantageous way having regard to the risk and return from the investment, the fund's diversity and liquidity and the ability of the fund to discharge its existing and prospective liabilities.

5.2 These obligations on a superannuation trustee require consideration of how an instalment warrant investment will be maintained on the death of a member of the fund. A member's benefits must be cashed as soon as practicable after the member dies: see regulation 6.21 of the SIS Regulations for SMSF's. The trustee must consider the long term implications of meeting loan repayments (the Instalment payments) when such a cashing is required.

5.3 Issues to be considered include:

5.3.1 are death benefits payable? If so how will that payment be funded?

5.3.2 is there a need to sell the asset? What affect does this have on the fund's investment strategy?

5.3.3 can the fund continue to service the Instalment payments without the deceased member's contributions?

5.3.4 what impact does the member's death have on the loan documents? For instance, were they a guarantor?

5.4 To address the issues enumerated above, a superannuation trustee should consider insurance against death, disability and trauma of the members of the fund. That is, the fund would insure against the death of the member and use the insurance payout to fund the obligation the superannuation trustee has to pay out the deceased member's benefits. This would leave the assets of the fund in place and should avoid the need to sell the asset underlying the Instalment warrant.

5.5 The insurance could be held in the superannuation fund, an advantage of which is that the part of the premiums payable for the insurance will be deductible to the superannuation trustee (see generally Subdivision 295-G of the *Income Tax Assessment Act 1997* (Cth) (**'the 1997 Act'**)), or outside of the superannuation fund by the other members. If the insurance is held outside the superannuation fund the other members would then contribute the proceeds to the superannuation fund (as non-concessional contributions, but subject to the contributions caps) in order to assist with paying out the death benefits and continuing to service the loan.

5.6 If the fund had anticipated the deceased member's continuing superannuation contributions to fund the Instalment warrant investment (the issue at enumerated **paragraph 5.3** above) there will be a need to source further contributions to the fund. In this regard the remaining members of the fund

would need to increase their contributions or an additional member (such as the deceased member's spouse if not already a member) could be added to the fund.

5.7 When entering into the instalment warrant documentation it is important that the bank documents are not drafted so that the death of a member will cause problems (e.g. enumerated **paragraph 5.4** above). This is a planning issue at the commencement of the warrant arrangement. If the deceased member is a guarantor on the documents the remaining members of the fund may need to provide additional security to satisfy the lender's requirements.

5.8 The following example illustrates how the death of a member can be a problem:

Ken, Andrew and Polly are members of a SMSF that has entered into an Instalment warrant arrangement that satisfies subsection 67(4A) of the SIS Act. Their superannuation fund acquires a property under the Instalment warrant arrangement. NAB is the bank providing finance.

Two years after settlement of the property, one of the three members dies in a car crash. The following example cash flows show how the death of a member can cause problems for the fund:

Fund cash balance (before Instalment warrant) - *Each member's account balance: $300,000*	*$900,000*
Funds acquired under Instalment warrant (60% LVR)	*$720,000*
Purchase price of property	*($1,260,000)*
Fund cash balance (after Instalment warrant entered)	***$360,000***
First two years super contributions (all three members) - *Each member's annual contribution: $66,666*	*$400,000*
First two year's rent (after tax)	*$120,000*
First two years loan repayments (P&I @ 9% on 5 year loan)	*($360,000)*
Cash balance after first two years	***$520,000***
Death benefits payable for death of member	*$353,333*[9]
Cash balance after first two years and cashing of benefits	***$166,667***

Without appropriate insurance (whether held in the superannuation fund or outside of it to be contributed later) each member would need to ensure that they are in a position to meet the cash flow requirements of the arrangement.

6 'REFINANCING' ISSUES

6.1 Paragraph 67(1)(b) of the SIS Act prohibits a trustee of a regulated superannuation from maintaining '*... an existing borrowing of money...*', whereas subsection 67(4A) of the SIS Act provides that the prohibition contained in subsection 67(1) of the SIS Act does not apply if a trustee of a regulated superannuation fund is '*... maintaining a borrowing of money ...*'. That is, the term 'existing' is used in paragraph 67(1)(b), but that word is not used in subsection 67(4A) of the SIS Act.

[9] Being the member's $300,000 opening balance + $173,333 (1/3 of the rent and additional contributions) - $120,000 (1/3 of the loan repayments.

6.2 Therefore, an issue to consider is whether a 'refinanced' loan falls within the scope of paragraph 67(4A)(a) of the SIS Act. Specifically, whether a refinanced loan is a '*... borrowing of 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 ...*'.

6.3 That is, the prohibition looks to whether an 'existing' borrowing is being maintained, whereas the exemption looks to whether there is a maintenance of a borrowing. It seems that it is irrelevant as to whether the borrowings are new borrowings or not. Relevantly, the elements that need to be present for the exception contained in subsection 67(4A) of the SIS Act to apply is for there to be (amongst other things):

6.3.1 a maintenance of borrowings;

6.3.2 under an 'arrangement'; whereby

6.3.3 money has been applied for the acquisition of an asset.

6.4 The use of the word 'existing' as contained in subsection 67(1) of the SIS Act requires the terms and parties relevant for the borrowings to be the same. However, for the purposes of subsection 67(4A) of the SIS Act, as long as there is a maintenance of a borrowing under an arrangement whereby the money borrowed has been used to acquire an asset, then the exception contained in subsection 67(4A) of the SIS Act will be satisfied. That is, the exception does not require that the terms and parties be the same through the 'arrangement', but only look to the trustee to the superannuation fund so as to ensure that the monies which are borrowed are always used for the same purposes, whether to acquire or maintain the borrowings used to acquire the asset.

6.5 That is, the legislature intended the term '*... maintain an existing borrowing of money ...*' contained in paragraph 67(1)(b) of the SIS Act to have a different meaning to the term '*... maintaining a borrowing of money ...*' as contained in subsection 67(4A) of the SIS Act.

(a) Statutory interpretation and construction – the use of different terms in subsection 67(4A) and paragraph 61(b) of the SIS Act

6.6 As a matter of statutory construction, the courts generally adopted a twofold approach in the interpretation of legislation based on the proposition that the use of words and expressions in legislation should be precise. Generally speaking:

6.6.1 where a word is used consistently in legislation, that word should be given the same meaning consistently; and

6.6.2 where the legislature could have used the same word but chose not to, the intention was to change the meaning (see for example *Scott v Commercial Hotel Merbein Pty Ltd* [1930] VLR 75). However, this principle only applies with respect to words which appear in the same legislation (see *Totalizator Agency Board v FC of T* (1996) 139 ALR 644 at 652).

6.7 Indeed, Irvine CJ in *Scott v Commercial Hotel Merbein Pty Ltd* [1930] VLR 75 observed that '*... though it is not to be conclusive, the employment of different language in the same Act may show that the Legislature had in view different objects ...*'. That is, because the term 'existing' is not used in subsection 67(4A) of the SIS Act, the context of the borrowings which are exempted by that subsection is different to that contained in paragraph 67(1)(b) of the SIS Act.

6.8 It should be noted that the proposition contained in **paragraphs 6.6.2** and **6.7** is a rebuttable presumption. It was observed by Higgins J in *Commissioner of Taxes (Vic) v Lennon* (1921) 29 CLR 579 at 590 that '*... although it is always well to use the same word for the same thing and not to change the language unless a change in meaning is intended, the presumption that arises from variations in language is of very slight force if the words in themselves are sufficiently clear*'. It is submitted that the '*... words in themselves ...* ' contained in subsection 67(4A) of the SIS Act are not '*... sufficiently clear ...*' as compared to those contained in paragraph 67(1)(b) of the SIS Act, with the result that the presumption expressed in **paragraphs 6.6.2** and **6.7** is not prima facie rebutted.

6.9 *Mort v Bradley* [1916] SALR 129 is authority for the proposition that the presumption may be rebutted if the context of certain words in one part of an Act compels an interpretation that is different as compared to the words contained in another part of the Act. It is submitted that because the words contained in the prohibition in subsection 67(1) of the SIS Act is used in the same context as the exception contained in subsection 67(4A) of the SIS Act, the presumption will again not be rebutted.

6.10 *Blood-Smyth v Carter* (1965) 83 WN (Pt 1) (NSW) 96 is authority for the proposition that a Court may not be bound to give a term the same meaning throughout an Act which is particularly large and frequently amended. Whilst the SIS Act may be 'large', it is not frequently amended. Further, it is noted that in *Freeman v Medical Practitioners Board of Victoria* [2000] VSC 547, the Court held that the use of different terminology was intended notwithstanding that the relevant Act was brief and had not been amended.

6.11 That is, as subsection 67(4A) of the SIS Act deals with the same subject matter as that contained in paragraph 67(1)(b) of the SIS Act (i.e. borrowings by trustees of superannuation funds), because there is a change in the use of words in subsection 67(4A) of the SIS Act as compared to paragraph 67(1)(b) of the SIS Act, those words will be taken to mean something different when compared.

6.12 It should be noted that section 15AC of the *Acts Interpretation Act 1901* (Cth) (**'Acts Interpretation Act'**) provides that:

> *'Where:*
>
> *(a) an Act has expressed an idea in a particular form of words; and*
>
> *(b) a later Act appears to have expressed the same idea in a different form of words for the purpose of using a clearer style;*
>
> *the ideas shall not be taken to be different merely because different forms of words were used.'*

6.13 That is, section 15AC of the Acts Interpretation Act provides that the statement of an idea in different words '*... for the purpose of using clearer style ...*' should not be taken to mean that a different meaning is intended. That is, the section applies if different wording is used merely because of a change of style rather than a change in substance to the legislation (see for example *Minister for Immigration and Ethnic Affairs v Scaiascia* (1991) FCR 364).

6.14 The High Court in *Commissioner of Taxation v Stone* (2005) 215 ALR 61, in comparing like provisions in the *Income Tax Assessment Act 1936* (Cth) (**'the 1936 Act'**) to the 1997 Act held that the provision in question had to be interpreted in the context of the earlier provisions. The Court made that conclusion on the basis that the re-write of the 1997 Act attempted to re-state the principles contained in the 1936 Act. However, it should be noted that the High Court did not consider section 15AC of the Acts Interpretation Act, but instead considered subsections 1-3(1) and (2) of the 1997 Act.[10]

6.15 It is submitted that the limitation contained in section 15AC of the Acts Interpretation Act does not apply to limit the interpretation contained in subsection 67(4A) to that contained in paragraph 67(1)(b) of the SIS Act as the words used in subsection 67(4A) of the SIS Act is of the same style (and not a 'clearer style') as contained in paragraph 67(1)(b) of the 1997 Act.

6.16 As a result, the limitation contained in paragraph 67(1)(b) of the SIS Act, being that the prohibition includes the maintenance of an 'existing' borrowing of money does not apply to subsection 67(4A), which merely provides that there is a maintenance of borrowing.

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[10] Subsection 1-3(1) of the 1997 Act provides that the 1997 Act contains the provisions of the 1936 Act '*... in a rewritten form...*'. Subsection 1-3(2) of the 1997 Act provides that if the 1936 Act '*... expressed an idea in a particular form of words ... and ...* [the 1997 Act] *... appears to have expressed the same idea in a different form of words in order to use a clearer or simpler style ... the ideas are not to be taken to be different just because different forms of words were used*'.

(b) Statutory interpretation and construction – reading words into legislation

6.17 As a general principle, the Courts consider that they are not at liberty to consider any words or sentences in legislation as superfluous or insignificant. As a result, all words must prima facie be given some meaning and effect. Griffith CJ in *Commonwealth v Baume* (1905) 2 CLR 405 observed that:

> *'... it was said to be a known rule in the interpretation of Statutes that such a sense is to be made upon the whole as that no clause, sentence, or word shall prove superfluous, void, or insignificant, if by any other construction they may all be made useful and pertinent.'*

6.18 It has been held that the principle is more compelling if the word in question have been added by amendment (as subsection 67(4A) of the SIS Act was). It was observed in *Transport Accident Commn v Treloar* [1992] 1 VR 447 at 462 that '*The rule of construction that no word is to be treated as superfluous ... is of particular importance where, as here, the word in question has been added by amendment...*'.

6.19 Similarly, the Courts are reluctant to modify the text of legislation by reading words into it. It was observed by Lord Mersey in *Thompson v Goold & Co* [1910] AC 409 at 420 that '*It is a strong thing to read into an Act of Parliament words which are not there, and in the absence of clear necessity it is a wrong thing to do*'. Similarly, it was observed by Stephen J in *Marshall v Watson* (1972) 124 CLR 640 at 649 that: '*Granted that there may seem to be lacking in the legislation powers which it might be thought the Legislature would have done well to include, it is no ...* [part] *... of the judicial function to fill gaps disclosed in legislation ... "If a gap is disclosed, the remedy lies in the amending Act" and not in a "usurpation of the legislative function under the thin disguise of interpretation"*'.

6.20 However, if an error in drafting legislation is clearly apparent and the context compelling, the Courts may be prepared to read words into legislation. In *Tokyo Mart Pty Ltd v Campbell* (1988) 15 NSWLR 275 at 283, Mahoney JA (with whom McHugh and Clarke JJA agreed) considered that:

> *'Legislative inadvertence may consist, inter alia, of either of two things. The draftsman may have failed to consider what should be provided for with respect of a particular matter and so fail to provide for it. In such a case, though it may be possible to conjecture what, had he adverted to it, he would have provided, the court may not, in my opinion, supply the deficiency. In the other case, the legislative inadvertence consists, not in failure to address the problem and determine what should be done, but in the failure to provide in the instrument express words appropriate to give effect to it. In the second case, it may be possible for the court, in the process of construction, to remedy the omission.'*

6.21 That is, the purpose of the legislation needs to be considered before the Courts will read words into legislation. McHugh JA in *Wentworth Securities Ltd v Jones* [1980] AC 74 at 105-6 held that if certain conditions were met, then the Courts could 'read in' words:

> *'First, the court must know the mischief with which the Act was dealing. Secondly, the court must be satisfied that by inadvertance Parliament has overlooked an eventuality which must be dealt with if the purpose of the Act is to be achieved. Thirdly the Court must be able to state with certainty what words Parliament would have used to overcome the omission if its attention had been drawn to the defect.'*

6.22 McHugh J repeated the preconditions in *Newcastle City Council v GIO General Ltd* (1997) 191 CLR 85.

6.23 It is submitted that the wording of subsection 67(4A) of the SIS Act is consistent with its apparent purpose – being that a trustee of a superannuation fund can borrow as long as certain preconditions are met. The omission of the word 'existing' has not rendered the provision defective.

(c) The borrowing needs to be pursuant to an 'arrangement'

6.24 Subsection 67(4A) of the SIS Act allows a trustee of a superannuation fund to borrow money, or maintain a borrowing of money *'... **under an arrangement** ... under which ... the money is or has been applied for the acquisition of an asset*'. [emphasis added]

6.25 The term 'arrangement' is not defined in the SIS Act. However, the term 'arrangement' has been given a very wide meaning in general law (see for example *Top Performance Motors Pty Ltd v Ira Berk (Queensland) Pty Ltd* 24 FLR 286). Indeed, and as an example, the term 'arrangement' is defined in subsection 995-1 of the 1997 Act as: '*Arrangement means any arrangement, agreement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable (or intended to be enforceable) by legal proceedings.*'

6.26 As a result, whilst a refinancing causes a new loan to come into existence, both the former loan and the new (refinanced) loan may be considered as part of an 'arrangement' under which money (whether from the former loan or the refinanced loan) is applied for the acquisition of an asset.

(d) When is the asset 'acquired'?

6.27 Subsection 67(4A) of the SIS Act requires the money from a borrowing (or maintained borrowing) to be applied for the acquisition of an asset. Whilst paragraph 67(4A)(b) of the SIS Act provides that the asset '*... is held on trust so that the RSF trustee acquires a beneficial interest in the ...*' asset, paragraph 67(4A)(c) of the SIS Act provides that the '*... RSF trustee has a right to acquire legal ownership of the ... asset ... by making one or more payments after acquiring the beneficial interest ...*'.

6.28 The acquisition of the asset (both in equity and at law) does not happen until the (instalment) payments (which are used to discharge the borrowings) occur. On a strict interpretation of subsection 67(4A) of the SIS Act, a trustee of a superannuation fund does not 'acquire' the asset until all of the instalments / payments have been made. That is, the 'acquisition' process involves a number of steps, which includes the holding of the relevant asset on trust for the trustee of the superannuation fund, and the instalment payment mechanism, after which the asset is eventually acquired by the trustee of the superannuation fund. A refinanced loan is a borrowing which allows a trustee of a superannuation fund to (eventually, after the loan is satisfied) acquire the asset.

6.29 Indeed, the purpose of subsection 67(4A) of the SIS Act is to allow a trustee of a superannuation fund to acquire an asset after making one or more (instalment) payments. A refinanced loan will be used so as to achieve that result.

(e) Maintaining a borrowing

6.30 An issue to consider is the scope of the term 'maintaining' for the purposes of subsection 67(4A) of the SIS Act. Specifically, when will one be 'maintaining' a borrowing which has been, or will be (see discussion under **subheading (d)** above) used to acquire an asset.

6.31 The Court in *Yeung & Anor v FC of T* 88 ATC 4193 considered that an income producing asset was maintained when a partnership used borrowed money to substitute those (borrowed) funds for funds initially contributed by the partnership to acquire an income producing property. It was observed that in that situation:

> *'What the partnership achieved by the borrowing ... was the maintenance of the income producing properties. Funds were withdrawn, but were replaced by loan funds and in the income-earning properties remained held by the six members of the family.'*

6.32 Similarly, in the context of a refinanced loan pursuant to a subsection 67(4A) of the SIS Act arrangement, the refinanced funds would be used to refinance monies which were initially used to acquire an asset. The refinanced loan allows for the 'maintenance' of the asset being acquired under the subsection 67(4A) of the SIS Act arrangement.

6.33 Regard should also be given to the observation of Hill J in *FC of T v Roberts & Smith* (1992) 37 FCR 246. Similar to the facts in *Yeung & Anor v FC of T*, in *FC of T v Roberts &* Smith, the partners in a law firm sought to reduce the partnership's capital account by borrowing to repay some of the capital to the partners of the firm. Hill J observed that:

> *'In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another;* ***the character of the refinancing takes on the same character as the original borrowing*** *and gives to the interest incurred the character of a working expense ...'* [emphasis added]

6.34 By analogy, and pursuant to Hill J's reasoning in *FC of T v Roberts & Smith*, the refinancing of a borrowing which was initially used to acquire an asset pursuant to subsection 67(4A) of the SIS Act, will take on the same character as the original borrowing. That is, as with the original loan, a refinanced loan will take '*... on the same character as the original borrowings ...*', with the result that the funds lent pursuant to a refinanced loan will be considered as being used for the purposes of acquiring an asset pursuant to subsection 67(4A) of the SIS Act.

(f) The Commissioner of Taxation's views – SMSFR 2009/2

6.35 The Commissioner has expressed its view as to the meaning of the term 'maintain an existing borrowing of money' for the purposes of subsection 67(1) of the SIS Act in SMSFR 2009/2 entitled *Self Managed Superannuation Funds: the meaning of 'borrowing money' or 'maintain an existing borrowing of money' for the purposes of section 67 of the Superannuation Industry (Supervision) Act 1993* (**'the Borrowings Ruling'**). The Commissioner observes at paragraph 13 of the Borrowings Ruling that:

> *'The prohibition and exceptions ...* [contained in section 67 of the SIS Act] *... also apply to the maintenance of an existing borrowing of money. An existing borrowing is maintained in circumstances where a borrowing arrangement previously entered into remains in place in circumstances where the SMSF trustee is obliged or intends to repay the money lent. This includes circumstances where an SMSF trustee has borrowed money and where an SMSF trustee has become liable for obligations under a borrowing arrangement entered into by another party.'*

6.36 It should be noted that the Borrowings Ruling is concerned with the meaning of (amongst other things) '*... maintain an existing borrowing of money... '* (per paragraph 67(1)(b) of the SIS Act) and not the term '*... maintain a borrowing of money ...*' (per subsection 67(4A) of the SIS Act).

6.37 The Commissioner provides his view as to the definition of the term '*... maintain an existing borrowing of money... '* in paragraph 87 of the Borrowings Ruling:

> *'... the prohibition against 'maintaining an existing borrowing' at its core contemplates a situation where an SMSF trustee has previously entered into a borrowing and that borrowing continues in existence. In this way, the provision recognises the ongoing nature of the arrangement and acts to prohibit the continuation of the conduct. This application puts beyond doubt the status of a borrowing on foot after the initial transfer of the money from the lender to the borrower.'*

6.38 With respect to refinancing, the Commissioner contends at paragraph 92 of the Borrowings Ruling that: '*... if the borrower pays out the original loan by borrowing replacement funds (commonly known as refinancing), it is considered that a new separate borrowing has been entered into*'. As authority for that proposition, the Commissioner cites both its own rulings (which of course are not law) and the High Court's decision in *FC of T v Roberts; FC of T v Smith*.

6.39 However, at paragraph 94 of the Borrowings Ruling, the Commissioner concedes that in the case of a refinance (which the Commissioner contends at paragraph 92 of the Borrowings Ruling constitutes a new borrowing) '*... it is necessary to consider the purpose of the borrowing to determine if an exception in section 67 applies. In particular, where an SMSF borrows money to refinance an existing borrowing as described in paragraph 92 of this Ruling, it will also be necessary to consider the purpose of the original borrowing together with the manner in which the new borrowing is applied to determine whether one of the exceptions in section 67 applies*'.

6.40 That is, it seems that the Commissioner is willing to accept that if a borrowing falls within an exception to the prohibitions contained in section 67 of the SIS Act, and the borrowing is refinanced which causes a new borrowing, then the new borrowing will take on the same character of the original borrowing.

7 SUPERANNUATION INTERESTS AS FINANCIAL PRODUCTS

7.1 Whether an arrangement which is established to comply with subsection 67(4A) of the SIS Act, is a 'financial product' or not will depend on its specific terms. For example, an arrangement established to comply with subsection 67(4A) of the SIS Act will fall within the 'financial product' provisions of the Corporations Act if:

7.1.1 the investor (e.g. a trustee of a superannuation fund) contributes an amount to a third party (for example a security trustee);

7.1.2 there is an intended generation of a financial return;

7.1.3 the investor (i.e. a trustee of a superannuation fund) has no day-to-day control over the use of the contribution.

7.2 Most of the subsection 67(4A) of the SIS Act arrangements will fall within the scope of the definition of 'financial products'. This is because the relationships required for a subsection 67(4A) of the SIS Act arrangement (i.e. trusts and lending relationships) will be viewed as a 'single arrangement', and established for the purposes of an investor obtaining a financial return or benefit.

7.3 To the extent that a subsection 67(4A) of the SIS Act arrangement is established with a pre-approved underlying property (i.e. one not chosen by a trustee of a superannuation fund, but an adviser / product establisher), then the 'financial investment' definition will be met.

(a) Corporations Act requirements for provision of financial services

7.4 Part 7.6 of the Subsection 911A(1) of the Corporations Act provides that *'... a person who carries on a financial services business ... must hold an Australian financial services licence covering the provision of the financial services'*. The term 'financial services business' is defined in section 761A of the Corporations Act as *'... a business of providing financial services'*, with the term 'financial services' defined in section 761A of the Corporations Act by reference to Division 4 of Part 7.1 of Chapter 7 of the Corporations Act. As section 766A of the Corporations Act, the term is defined as follows:

'For the purposes of this Chapter ... a person provides a financial service if they:

(a) provide financial product advice ...; or

(b) deal in a financial product ...; or

(c) make a market for a financial product ...; or

(d) operate a registered scheme ...; or

(e) provide a custodial or depository service ...; or

(f) engage in conduct of a kind prescribed by regulations made for the purposes of this paragraph.'

7.5 That is, section 766A of the Corporations Act provides that providing a 'financial service' includes dealing in financial products. The term 'dealing' for the purposes of paragraph 766A(1)(b) of the Corporations Act is defined in subsection 766C(1) of the Corporations Act as:

'For the purposes of this Chapter, the following conduct (whether engaged in as principal or agent) constitutes dealing in a financial product:

(a) applying for or acquiring a financial product;

(b) issuing a financial product;

(c) in relation to securities or managed investment interests – underwriting the securities or interests;

(d) varying a financial product;

(e) disposing of a financial product.

7.6 Subsection 766A(2) of the Corporations Act provides (amongst other things) that the *Corporations Regulations* 2001 (Cth) ('**the Corporations Regulations**') may set out *'... the circumstances in which persons are taken to provide,* ***or taken not to provide, a financial service*** *...'* [emphasis added]. Of note, regulation 7.1.29(1) provides that *'... a person who provides an eligible service is taken not to provide a financial service ...'*. Regulation 7.1.29(4) of the Corporations Regulations includes as an 'exempt service' advice relating to taxation issues. Regulation 7.1.29(5) of the Corporations Regulations includes as 'exempt services' advice relating to superannuation funds, with sub-regulation 7.1.29(5)(c) of the Corporations Regulations carving out from the scope of 'exempt services':

7.6.1 advice relating to the *'... acquisition or disposal by the superannuation fund of specific financial products or classes of financial products ...'* (see sub-regulation 7.1.29(5)(c)(i) of the Corporations Regulations);

7.6.2 *'... a recommendation that a person acquire or dispose of a superannuation product ...'* (see sub-regulation 7.1.29(5)(c)(ii) of the Corporations Regulations). However, it is noted that regulation 7.1.29A of the Corporations Regulations provides that sub-regulation 7.1.29(5)(c)(i) of the Corporations Regulations *'... does not apply to a recommendation by a recognised accountant in relation to a self-managed superannuation fund'*;

7.6.3 *'... a recommendation in relation to a person's existing holding in a superannuation product to modify an investment strategy or contribution level ...'* (see sub-regulation 7.1.29(5)(c)(iii) of the Corporations Regulations).[11]

7.7 An issue to determine is what a 'financial product' is. The term 'financial product' for the purposes of Chapter 7 of the Corporations Act is defined in section 761A of the Corporations Act by reference to Division 3 of Part 7.1 of Chapter 7 of the Corporations Act.

7.8 Section 762A of the Corporations Act provides an overview with respect to the approach to be taken when defining what a financial product is. Specifically:

7.8.1 ***subsection 762A(1) of the Corporations Act*** — which provides that subject to the specific inclusions[12] and overriding exclusions,[13] Subdivision B of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act provides a 'general definition' of the term 'financial product';

7.8.2 ***subsection 762A(2) of the Corporations Act*** — which provides that subject to the overriding exclusions,[14] Subdivision C of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act provides for the identification of specific facilities that are 'financial products', whether or not they fall within the 'general definition'.

7.8.3 ***subsection 762A(3) of the Corporations Act*** — which provides that notwithstanding that a facility may fall within the 'general definition' of financial product, or be identified specifically as a financial product, if the facility falls within the 'overriding exclusions' contained in Subdivision D of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act, then the facility will not be a financial product.

7.9 It should be noted that section 762A of the Corporations Act requires the identification of a 'facility' in determining whether the 'general definition', 'specific inclusion' or 'overriding exclusion' applies. The term 'facility' is provided for in section 762C of the Corporations Act as:

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[11] Note our discussion regarding 'switching' below.
[12] See subsection 762A(2) of the Corporations Act and Subdivision C of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act.
[13] See subsection 762A(3) of the Corporations Act and Subdivision D of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act.
[14] See subsection 762A(3) of the Corporations Act and Subdivision D of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act.

'... facility includes ... intangible property an arrangement[15] or a term of an arrangement (including a term that is implied by law or that is required by law to be included); or ... a combination of intangible property and an arrangement or term of an arrangement ...' .

7.10 An arrangement that satisfies the requirements of subsection 67(4A) of the SIS Act will be a 'facility' as defined in section 762C of the Corporations Act.

7.11 It is further noted that section 762B of the Corporations Act provides that if a financial product is a component of a facility that has other components (which are themselves not financial products), then it is only the financial product component that is affected by Chapter 7 of the Corporations Act.

(b) The 'general definition' of financial product

7.12 As mentioned above, Subdivision B of Division 3 of Part 7.1 of Chapter 7 of the Corporations Act (sections 763A to 763E of the Corporations Act), subject to the specific inclusions under section 764A of the Corporations Act and the specific exclusions contained in section 765A of the Corporations Act. Subsection 763A(1) of the Corporations Act provides that *'... a financial product is a facility through which, or through the acquisition of which, a person does one or more of the following...'*:

7.12.1 makes a financial investment;

7.12.2 manages financial risk;

7.12.3 makes non-cash payments.

(i) Making a financial investment

7.13 Paragraph 763A(1)(a) of the Corporations Act provides that a 'financial product' includes making a financial investment. Section 763B of the Corporations Act establishes when a person makes a financial investment:

*'For the purposes of this Chapter, a person (the **investor**) **makes a financial investment** if:*

*(a) the investor gives money or money's worth (the **contribution**) to another person and any of the following apply:*

(i) the other person uses the contribution to generate a financial return, or other benefit, for the investor;

(ii) the investor intends that the other person will use the contribution to generate a financial return, or other benefit, for the investor (even if no return or benefit is in fact generated);

(iii) the other person intends that the contribution will be used to generate a financial return, or other benefit, for the investor (even if no return or benefit is in fact generated); and

(b) the investor has no day-to-day control over the use of the contribution to generate the return or benefit.'

7.14 Paragraph 6.56 of the Explanatory Memorandum to the Act which introduced section 763B of the Corporations Act provides as follows:

'The concept of 'making a financial investment' in proposed section 763B is broadly based on the concept of managed investment scheme in the existing Corporations Act. It has 3 key elements:

- *The investor contributing money or money's worth;*

[15] The term 'arrangement' is in turn defined in section 761A of the Corporations Act as '...a *contract, agreement, understanding, scheme or other arrangement (as existing from time to time):*
(a) whether formal or informal, or partly formal and partly informal; and
(b) whether written or oral, or partly written and partly oral; and
(c) whether or not enforceable, or intended to be enforceable, by legal proceedings and whether or not based on legal or equitable rights.'

- *The generation or intended generation of a financial return or benefit. This takes account of the possibility of an investment giving rise to a loss. While the intention should be to generate a financial benefit, this may not always be the outcome; and*

- *The investor having no day-to-day control over the use of money to generate the return.'*

7.15 It is noted that the definition of 'financial investment' is similar to the definition of 'managed investment scheme' contained in section 9 of the Corporations Act,[16] except that there is no requirement in the definition of 'financial investment' to show a pooling or a common enterprise. It is further noted that a contribution may be (for example) used to generate a financial return or other benefit. The term 'benefit' is defined in section 9 of the Corporations Act to *include '... any benefit, whether by way of payment of cash or otherwise.'*

7.16 Each particular arrangement would need to be considered in order to determine whether it meets the requirements of being a 'financial investment'. For example, a requirement contained in paragraph 763B(a) of the Corporations Act is that an *'... investor gives money ... to another person ...'*. If an investor (such a trustee of a SMSF) does not give money to another person, then the provision cannot be satisfied. However, a requirement of subsection 67(4A) of the SIS Act is that money (borrowed by a trustee of a superannuation fund '... *has been applied for the acquisition of an asset ...'* – i.e. is the money given to another person (e.g. the security trustee) when being applied for the acquisition of the asset?

7.17 Further, query whether if a bare trust arrangement is established in order to qualify for subsection 67(4A) of the SIS Act whether a trustee of a self managed superannuation fund that invests in the arrangement will be 'giving' money to a security trustee. However, the better view is that a payment by a trustee of a superannuation fund to a security trustee (or bare trustee) which falls within the scope of subsection 67(4A) of the SIS Act will satisfy the condition of paragraph 673B(1)(a) of the Corporations Act.

7.18 It is noted that paragraph 763B(b) of the Corporations Act provides that investments that involve a person taking active day-to-day control of the use of their contribution (e.g. general partnerships and joint ventures in the ordinary course) will fall outside of the definition of 'financial investment'. Arguably, to the extent that the day-to-day control of an arrangement which complies with subsection 67(4A) of the SIS Act rests with a trustee of a self-managed superannuation fund, then such an arrangement will not fall within the definition of a 'financial investment' with the result that paragraph 763A(1)(a) of the Corporations Act is not satisfied. That is, such an arrangement will not be a 'financial product'.

7.19 An arrangement which includes both a trust arrangement, and a credit arrangement (see discussion below regarding credit arrangements) may fall within the scope of the definition of 'financial investment' contained in section 763B of the Corporations Act if:

7.19.1 the investor (e.g. a trustee of a superannuation fund) contributes an amount to a third party (for example a security trustee);

7.19.2 there is an intended generation of a financial return[17];

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[16] The term 'managed investment scheme' is defined as:

(a) a scheme that has the following features:

(i) people contribute money or money's worth as consideration to acquire rights (interests) to benefits produced by the scheme (whether the rights are actual, prospective or contingent and whether they are enforceable or not);

(ii) any of the contributions are to be pooled, or used in a common enterprise, to produce, or consisting of rights or interests in property, for the people (the members) who hold interests in the scheme (whether as contributors to the scheme or as people who have acquired interests from holders);

(iii) the members do not have day-to-day control over the operation of the scheme (whether or not they have the right to be consulted or to give directions); or

(b) a time-sharing scheme;

[17] In the event that there is no intended generation of a financial return, the 'sole purpose test' contained in section 62 of the SIS Act may be breached (see also Case 43/95, ATC 374 — the 'Swiss Chalet Case'). Further, the trustee of a superannuation fund has an obligation under trust law to attempt to secure the best financial return for the superannuation fund (being the trust). It was held in *Cowan v Scargill* [1985] 1 Ch 270 that: *'When the purpose of the trustee is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests. In the case of a power of*

7.19.3 the investor (i.e. a trustee of a superannuation fund) has no day-to-day control over the use of the contribution.

7.20 To the extent that a subsection 67(4A) of the SIS Act arrangement is established with a pre-approved underlying property (i.e. one not chosen by a trustee of a superannuation fund, but an adviser / product establisher), then the 'financial investment' definition will be met.

(ii) Managing financial risk

7.21 As discussed above, paragraph 763A(1)(b) of the Corporations Act provides that a 'financial product' includes a facility that 'manages financial risk'. Section 763C of the Corporations Act provides a definition of managing financial risk, being:

> *'For the purposes of this Chapter, a person **manages financial risk** if they: ... manage the financial consequences to them of particular circumstances happening; or ... avoid or limit the financial consequences of fluctuations in, or in the value of receipts or costs (including prices and interest rates).'*

7.22 This provision is intended to catch insurance and derivatives when used for hedging (see paragraph 6.61 of the Explanatory Memorandum). Although an arrangement constituted under subsection 67(4A) of the SIS Act requires that *'... the rights of the lender as against the RSF trustee for default on the borrowings ... are limited to the rights related to the original asset or the replacement ...'*, this is not equivalent to managing financial risks as defined in section 763C of the Corporations Act. That is, the limitation of liability is embedded in the terms of the borrowing arrangement, which is not used for managing the risk as contemplated by section 763C of the Corporations Act. As a result, the managing financial risk element contained in paragraph 763A(1)(b) of the Corporations Act is not considered to be relevant in determining whether a subsection 67(4A) of the SIS Act arrangement meets the general definition of financial product.

(iii) Non-cash payments

7.23 As discussed above, paragraph 763A(1)(c) of the Corporations Act provides that a 'financial product' includes a facility under which 'non- cash payments' may be made. Subsection 763D(1) of the Corporations Act provides that a *'... person makes non-cash payments if they make payments, or cause payments to be made, otherwise than by the physical delivery of Australian or foreign currency in the form of notes and / or coins'*. The non-cash payment element contained in paragraph 763A(1)(c) of the Corporations Act will usually not be relevant in determining whether a subsection 67(4A) of the SIS Act arrangement meets the general definition of financial product.

(c) Whether subsection 67(4A) arrangements are 'derivatives'

7.24 A 'derivative' is a financial product for the purposes of Chapter 7 of the Corporations Act (see paragraph 764A(1)(c) of the Corporations Act). The term 'derivative' is in turn defined in subsection 761D(1) of the Corporations Act, which provides that:

> *'(1) For the purposes of this Chapter, subject to subsections (2), (3) and (4), a **derivative** is an arrangement in relation to which the following conditions are satisfied:*
>
> *(a) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time consideration of a particular kind or kinds to someone; and*
>
> *(b) that future time is not less than the number of days, prescribed by regulations made for the purposes of this paragraph, after the day on which the arrangement is entered into; and*
>
> *(c) the amount of the consideration, or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:*
>
> *(i) an asset;*
>
> *(ii) a rate (including an interest rate or exchange rate);*

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investment ... the power must be exercised so as to yield the best return for the beneficiaries, and the prospects for the yield of income and capital appreciation both have to be considered in judging the return from investment'.

(iii) an index;

(iv) a commodity.'

7.25 Subsection 761D(3) of the Corporations Act provides that certain things are not derivatives for the purposes of Chapter 7 even if they fall within subsection 761D(1) of the Corporations Act definition, which includes an arrangement that includes:

7.25.1 an option to purchase or sell tangible property (other than currency) at a future date;

7.25.2 which is to be settled by delivery of the property; and

7.25.3 where neither usual market practice, nor rules of certain markets or facilities permit the seller's obligations to be matched with an offsetting arrangement.

7.26 As with the definition of 'financial investment', whether a subsection 67(4A) of the SIS Act arrangement falls within the scope of the definition of 'derivative' in section 761D of the Corporations Act will depend on the terms of the particular arrangement. If the amount of consideration to be paid (i.e. the 'final instalment payment') by an investor is not based on the value of the underlying asset, but rather (for example) outstanding loan balances, then paragraph 761D(1)(c) of the Corporations Act will not apply. However, if a party to the arrangement (for example a 'security trustee') is required to (for example) pay a 'net proceed' amount to an investor / trustee of a self- managed superannuation fund which is based on the value of the asset held subject to a subsection 67(4A) of the SIS Act arrangement, then arguably the definition of a 'warrant' contained in section 761D(1) of the Corporations Act will apply. That is, the specific terms of the arrangement need to be considered.

7.27 Further, subsection 761D(2) of the Corporations Act provides that:

'Without limiting subsection (1), anything declared by the regulations to be a derivative for the purposes of this section is a derivative for the purposes of this Chapter. A thing so declared is a derivative despite anything in subsections (3) and (4).'

7.28 Sub-regulation 7.1.04(2) of the Corporations Regulations in turn provides that:

'For subsection 761D(2) of the Act, and subject to this regulation, an arrangement is declared to be a derivative if the following conditions are satisfied in relation to the arrangement...

(a) the arrangement is not a foreign exchange contract;

(b) under the arrangement, a party to the arrangement must, or may be required to, provide at some future time (which may be less than 1 day after the arrangement is entered into) consideration of some particular kind or kinds to someone;

(c) the amount of the consideration or the value of the arrangement, is ultimately determined, derived from or varies by reference to (wholly or in part) the value or amount of something else (of any nature whatsoever and whether or not deliverable), including, for example, one or more of the following:

(i) an asset;

(ii) a rate (including an interest rate and an exchange rate);

(iii) an index;

(iv) a commodity.

7.29 The definitions of 'derivative' contained in both subsection 761D(1) of the Corporations Act (see **paragraph 7.24** above) and sub-regulation 7.1.04(2) of the Corporations Regulations (see **paragraph 7.28** above) are similar.

7.30 Therefore, although 'instalment warrants' may fall within the definition of 'derivatives', it is possible that it would be excluded under the exemption in subsection 761D(3) of the Corporations Act.

(d) Arrangement provision — bundling specific components to constitute a 'financial product'

7.31 To the extent that specific components of a subsection 67(4A) of the SIS Act arrangement are not 'financial products' in their own right, but would be considered as such when viewed as a single scheme, then section 761B of the Corporations Act[18] will apply to ensure that *'... the arrangements are ... to be treated as if they together constituted a single arrangement'*. That is, a bundling of the trust arrangement along with the credit arrangement will be considered a single arrangement that will meet the definition of 'financial product'.

(e) 'Incidental products'

7.32 Regard needs to be given to the 'incidental financial product' provisions. Section 763E of the Corporations Act provides that if something that would otherwise be a financial product because of the general definition contained in section 763A of the Corporations Act, is an 'incidental product' and will not be a 'financial product'. Paragraph 6.54 of the Explanatory Memorandum to the Act which introduced section 763E of the Corporations Act provides that:

> *'Proposed section 763E is intended to ensure that the definition of financial product' does not pick up a range of consumer transactions that have an element, but not the primary purpose, of for example managing a financial risk. ... Under proposed section 763E where the financial product purpose (making a financial investment, managing a financial risk, or making a non-cash payment) is incidental to the main purpose of a facility, it is not to be regarded as a financial product.'*

7.33 If an arrangement views as a single arrangement (as provided by section 761B of the Corporations Act) falls within the general definition of 'financial product', then the 'incidental' nonfinancial product elements of the arrangement (e.g. the mortgage element) **will not** be sufficient to cause the 'incidental financial product' provisions to apply and therefore cause the arrangement to fall outside of the definition of 'financial product'.

8 PRODUCT DISCLOSURE REQUIREMENTS

(a) Application of Division 2 of Part 7.9 of the Corporations Act

8.1 Division 2 of Part 7.9 of the Corporations Act broadly requires that a Product Disclosure Statement be provided to a person before the person acquires a 'financial product', where the person is acquiring the product as a 'retail client'.[19] The effect of subsection 1010A(1) of the Corporations Act provides that Division 2 of Part 7.9 of the Corporations Act does not apply in relation to the offering of 'securities', to which Chapter 6C of the Corporations Act applies.

8.2 The Division 2 of Part 7.9 of the Corporations Act regime is considered to apply to warrants like those written over real property, as a subsection 67(4A) arrangement may be a 'derivative' and therefore a 'financial product', and they do not fall within the definition of 'security' in paragraph 761A(c) of the Corporations Act,[20] which requires (amongst other things) *'... a legal or equitable right or interest in ...'* either a share in a body or a debenture of a body.

8.3 It is noted that regulation 7.9.07A of the Corporations Regulations is intended to apply specific conditions with respect to PDSs over 'warrants'. Sub-regulation 7.9.07A(2) of the Corporations Regulations provides that:

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[18] Section 761B of the Corporations Act provides that:
If:
(a) an arrangement, when considered by itself does not constitute a derivative, or some other kind of financial product; and
(b) that arrangement, and one or more other arrangements, if they had instead been a single arrangement, would have constituted a derivative or other financial product; and
(c) it is reasonable to assume that the parties to the arrangements regard them as constituting a single scheme;
the arrangements are, for the purposes of this Part, to be treated as if they together constituted a single arrangement.

[19] The term 'retail client' is defined in section 761G of the Corporations Act.

[20] The term 'security' for the purposes of Chapter 6D of the Corporations Act has (according to subsection 700(1) of the Corporations Act) *... the same meaning as it has in Chapter 7, but does not include a security referred to in paragraph (e) of the definition of security in section 761A'.*

'For paragraph 1020G(2)(a) of the Act, section 1010A of the Act is modified by adding after subsection 1010A(1):

"(1A) Despite subsection (1), this Part applies in relation to a financial product to which regulation 7.9.07A of the Corporations Regulations 2001 applies".'

8.4 It is further noted that paragraph 1020G(2)(a) of the Corporations Act was repealed from the Corporations Act by Act No 141 of 2003, effective from 18 December 2003.

8.5 Some warrants are securities, and therefore fall within the Chapter 6D of the Corporations Act disclosure regime, whilst others are 'derivatives' and are subject to the Part 7.9 of the Corporations Act disclosure regime. As discussed above, in order for a 'warrant' to be a 'security', there must be a legal and equitable interest in issued shares or debentures (see paragraph 761 A(c) of the Corporations Act). Whilst the proper characterisation depends on the particular arrangement, ASIC has provided the following comments:[21]

*'**Warrants**, depending on their type, can be either a security or derivative. Under the security definition in s761A(c) of the Corporations Act, there must be a legal or equitable interest in issued shares or debentures for the instrument to be a security. This means you need to look at the terms of the product in question to determine whether it is a security or derivative.*

***'Fully-covered warrants'**, as defined in the ASX Business Rules, may be a security as it is subject to a 'cover arrangement'. ASX Business Rule 8.1 defined a cover arrangement as involving some form of trust over relevant issued securities.*

***Instalment warrants** that are generally issued as part of a cover arrangement are a security, in view of the legal or equitable interest in the underlying securities.'*

(b) Application of Part 7.9 of the Corporations Act disclosure regime

8.6 Subject to certain exceptions,[22] the Corporations Act provides that a retail client must be given a Product Disclosure Statement in three situations, being:

8.6.1 ***a recommendation situation*** – section 1012A of the Corporations Act – in the course of providing personal financial advice to a client, a regulated person[23] has recommended that the client acquire the financial product, and the acquisition is either by way of issue to the client, or by way of transfer to the client under a regulated secondary sale to which the PDS requirements apply (see subsection 1012A(3) of the Corporations Act);

8.6.2 ***an issue situation*** – section 1012B of the Corporations Act – where (for example) a regulated person *'... offers to issue the financial product to the person; or ... offers to arrange for the issue of the financial product to the person ...'* (see subsection 1012B(3) of the Corporations Act).

8.6.3 ***a sale situation*** — section 1012C of the Corporations Act — where a regulated person offers to sell, or actually sells a financial product to a person that will be considered either:

(a) an off-market sale by a controller of an issuer;

(b) a sale which is an indirect issue of a financial product; or

(c) a sale amounting to an indirect off-market sale by the controller of the issuer.

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[21] See 'Financial Services Reform: Security or Derivative?' in *Australian Securities & Investments Commission Newsletter*, Issue 51, August 2002.

[22] See sections 1012D to 1012G and 1014E of the Corporations Act.

[23] The term 'regulated person' is defined in section 1011B of the Corporations Act to include an issuer of a financial product, in certain circumstances a seller of a financial product (i.e. a sale that requires a PDS under subsection 1012C(5), (6) or (8) of the Corporations Act), or an AFS licensee, an authorised representative of an AFS Licensee, a person who ought to hold an AFS licence but does not, or a person who is not required to hold an AFS Licence because of an exemption in subsection 911 A(2)(j), (k) or (1) of the Corporations Act.

8.7 Whether a client is a 'retail client' in respect of a particular financial product (e.g. a 'superannuation interest') depends on the nature of the financial product. A person may be considered a 'retail' client with respect to one financial product, but not another.

8.8 Subsection 761G(6) of the Corporations Act provides that all 'clients' are retail clients with respect to 'superannuation products', by providing that: *'For the purposes of this Chapter ... if a financial product provided to a person is a superannuation product ... the product is provided to a person as a retail client...'*.

(c) Application of Regulation 7.9.07A of the Corporations Regulations

8.9 As discussed above, regulation 7.9.07A of the Corporations Act ostensibly imposes additional PDS requirements with respect to 'warrants'. The term 'warrant' is defined in regulation 1.0.02 of the Corporations Regulations as:

> *'Warrant means a financial product:*
>
> *(a) that is:*
>
> *(i) a derivative under section 761D of the Act; or*
>
> *(ii) a financial product that would, apart from the effect of paragraph 761D(3)(c) of the Act, be a derivative for section 761D of the Act, and is excluded by that paragraph only because:*
>
> *(A) it is a security under paragraph (c) of the definition of security in section 761A of the Act; or*
>
> *(B) it is a legal or equitable right or interest mentioned in subparagraph 764A(1)(b)(ii) of the Act; or*
>
> *(C) it is a legal or equitable right or interest mentioned in subparagraph 764A (1)(ba)(ii) of the Act; and*
>
> *(b) that is transferable.'*

8.10 Considering each of the elements of the definition of 'warrant' contained in regulation 1.0.02 of the Corporations Regulations:

8.10.1 If instalment warrants arrangements meet the definition of 'derivative' for the purposes of section 761D of the Corporations Act then paragraph (a)(i) of the definition of 'warrant' in regulation 1.0.02 of the Corporations Regulations will be satisfied;

8.10.2 however, the effect of the second limb of the definition of 'warrant' is that subsection 67(4A) of the SIS Act arrangements which have as their underlying asset a share, debenture, or interest in a managed investment scheme may fall within the definition of 'warrant', notwithstanding that they do not meet the definition of 'derivative'. As a result, 'warrants' have a wider application than 'derivative';

8.10.3 the transferability issue will depend on the terms of the particular arrangement. *Norman v FC of T* (1963) 109 CLR 9 is authority for the proposition that 'equitable property'[24], such as the 'beneficial interest' obtained by the Investor under an subsection 67(4A) SIS Act arrangement, is capable of being assigned. That is, unless specifically prohibited under the terms of the particular arrangement, a subsection 67(4A) SIS Act arrangement will be transferable (e.g. assignable).

(d) Use of the words 'instalment warrant' in the heading of subsection 67(4A) of the SIS Act and extrinsic materials

8.11 The term 'instalment warrant' is used in the heading to subsection 67(4A) of the SIS Act, and in other extrinsic materials such as the Explanatory Memorandum to the Act which introduced subsection 67(4A) of the SIS Act.

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[24] i.e. *'... any right or title, such as the right of a beneficial); under a trust, enforced in equity but not at common law...'* — see paragraph 6-015 of Meagher, Gummow & Lehane's Equity Doctrines & Remedies.

8.12 As a matter of statutory interpretation, headings to sections do not form part of the section. Section 13 of the Acts Interpretation Act provides that:

> *'(1) The headings of the Parts Divisions and Subdivisions into which any Act is divided shall be deemed part of the Act.*
>
> *(2) Every schedule to an Act shall be deemed to form part thereof*
>
> *(3) No marginal note, footnote or endnote to an Act, and **no heading to a section of an Act, shall be taken to be part of the Act**.'* [emphasis added]

8.13 Latham CJ in *Silk Bros Ply Ltd v State Electricity Comm (Vic)* (1943) 67 CLR 1 held that:

> *'The headings in a statute ... can be taken into consideration in determining the meaning of a provision where that provision is ambiguous, and may sometimes be of service in determining the scope of a provision ... "But where the enacting words are clear and unambiguous, the title, or headings, must give way, and full effect must be given to the enactment" (Bennett v Minister for Public Works (NSW) (1908) 7 CLR 372 at 383).'*

8.14 Murray CJ in *Ragless v Prospect District Council* [1922] SASR 299 at 311 provided a summary of the law with respect to headings at general law:

> *'I think the rules ... [as to the use of headings] ... may be stated thus:*
>
> *1. If the language of the sections is clear, and is actually inconsistent with the headings, the headings must give way.*
>
> *2. If the language of the sections is clear, but, although more general, is not inconsistent with the headings, the sections must be read subject to the headings.*
>
> *3. If the language of the sections is doubtful or ambiguous, the meaning which is inconsistent with the headings must be adopted.'*

8.15 As a result, the use of the term 'instalment warrant' in the heading to subsection 67(4A) of the SIS Act is not relevant to the operation of the section. The arrangement does not need to be a 'warrant' as defined in the Corporations Act or Corporations Regulations.

8.16 It is noted that section 15AA of the Acts Interpretation Act provides that in the *'... interpretation of a provision of an Act, a construction that would promote the purpose or object underlying the Act (whether or not the purpose or object is expressly stated in the Act or not) shall be preferred to a construction that would not promote that purpose or construction'*. Further, section 15AB of the Interpretation Act provides that extrinsic materials may be used in the interpretation of a provision of an Act, which includes *'... matters not forming part of the Act that are set out in the document containing the text ...'* (e.g. a heading, explanatory memorandum and second reading speeches). However, there is authority for the proposition that extrinsic materials may only be used to confirm the literal meaning of legislation – i.e. extrinsic material may be referred to, but they cannot alter the interpretation of interpretation which a court, without reference to the materials, would place upon the provision.

8.17 The High Court in *Re Australian Federation of Construction* Contractors*; Ex parte Billing* (1986) 68 ALR 416 at 420 observed that:

> *'Reliance is also placed on a sentence in the second-reading speech of the Minister when introducing the Consequential Provisions Act, but that reliance is misplaced. Section 15AB of the Acts Interpretation Act 1901 (Cth), as amended, does not permit recourse to that speech for the purpose of departing from the ordinary meaning of the text unless either the meaning of the provision is to be construed is ambiguous or obscure or in its ordinary meaning of the provision to be construed is ambiguous or obscure or if its ordinary meaning leads to a result that is manifestly absurd or is unreasonable. In our view neither of those conditions is satisfied in the present case.'*

8.18 In order for extrinsic material to change the interpretation of legislation which would otherwise had been given by a court, it is necessary for either paragraph 15AB(1)(b)(i) or (ii) of the Interpretation Act to apply, being that *'... material not forming part of the Act ...'* may be considered:

'... to determine the meaning of the provision when:

(i) the provision is ambiguous or obscure; or

(ii) the ordinary meaning conveyed by the text of the provision taking into account its context in the Act and the purpose or object underlying the Act leads to a result that is manifestly absurd or is unreasonable.'

8.19 That is, the courts must conclude, without taking into account any materials which do not form part of an Act, that the provision considered is 'ambiguous' or 'obscure' or that, taking into account the purpose of an Act, that the ordinary meaning leads to a result that is 'manifestly absurd' or 'unreasonable'. In the context of section 15AB of the Interpretation Act, Mason CJ, Wilson and Dawson JJ in *Re Bolton; Ex parte Beane* (1987) 70 ALR 225 at 227-8 observed that:

'The words of a Minister must not be substituted for the text of the law. ... It is always possible that through oversight or inadvertence the clear intention of the Parliament fails to be translated into the text of the law. However unfortunate it may be when that happens, the task of the court remains clear. The function of the court is to give effect to the will of Parliament as expressed in the law.'

8.20 Further, *Brennan v Comcare* (1994) 122 ALR 615 is authority for the proposition that section 15AB of the Interpretation Act permits, but does not oblige, a court to refer to extrinsic materials.

8.21 As a result, notwithstanding that the term 'instalment warrant' is used in the heading of subsection 67(4A) of the SIS Act, and extrinsic materials related to the subsection, the arrangement does not need to be a 'warrant' (i.e. a form of a financial product) as defined and regulated by the Corporations Act.

9 FINANCIAL PRODUCT SWITCHING ADVICE

9.1 Generally speaking, a Statement of Advice is required whenever personal advice is given to a retail client – either as the means by which advice is provided, or as a record of the advice. Section 947D of the Corporations Act requires additional information to be provided in a Statement of Advice with respect to financial product switching. Subsection 947D(1) of the Corporations Act provides that:

'This section applies (subject to subsection (4)) if the advice is or includes a recommendation that the client dispose of, or reduce the client's interest in, all or part of a particular financial product and instead acquire all or part of, or increase the client's interest in, another financial product.'

9.2 Subsection 974C(5) of the Corporations Act provides that the further information required to be given under section 974D of the Corporations Act must be included in the Statement.

9.3 As discussed above, regulation 7.1.29(5)(c) of the Corporations Act provides that 'exempt advice' – i.e. advice that does not fall within the carve-out from being a 'financial service' as provided for in subsection 766A(2) of the Corporations Act – **does not** include advice relating to the:

9.3.1 '... acquisition or disposal by the superannuation fund of specific financial products or classes of financial products ...';

9.3.2 *'... a recommendation that a person acquire or dispose of a superannuation product ...'*; or

9.3.3 '... a recommendation in relation to a person's existing holding in a superannuation product to modify an investment strategy or contribution level ...'

9.4 That is, any advice given to a retail client (such as a trustee of a superannuation fund), which relates to the disposal or reduction of an interest in all or part of a particular product, or the increase in an interest in another financial product (i.e. recommend a switch), then additional information must be included in the client's Statement of Advice.

9.5 Subsection 947D(2) of the Corporations Act outlines the additional information that is required in a Statement of Advice when a client obtains advice which deals with product switching, by providing that:

'(1) The following additional information must be included in the Statement of Advice:

(a) information about the following, to the extent that the information is known to, or could reasonably be found out by, the providing entity:

(i) any charges the client will or may incur in respect of the disposal or reduction;

(ii) any charges the client will or may incur in respect of the acquisition or increase;

(iii) any pecuniary or other benefits that the client will or may lose (temporarily or otherwise) as a result of taking the recommended action;

(b) information about any other significant consequences for the client of taking the recommended action that the providing entity knows, or ought reasonably to know, are likely;

(c) any other information required by regulations made for the purposes of this paragraph;

(d) unless in accordance with the regulations, for information to be disclosed in accordance with paragraph (a), any amounts are to be stated in dollars.'

9.6 That is, section 947D of the Corporations Act provides that the Statement must include (amongst other things) *'...information about any other significant consequences for the client of taking the recommended action that the providing entity knows, or ought reasonably to know, are likely...'*.

9.7 It should also be noted that subsection 974D(3) of the Corporations Act provides that if an advisor knows, or is reckless as to whether the client will or may incur charges, lose benefits or have any other consequences, but does not know or cannot reasonably find out what the relevant consequences are, then the Statement of Advice must include a statement to the effect that there will or may be such charges, losses or consequences but that the Licensee / Representative does not know what they are.

9.8 It is noted that the document *Refinements to Financial Services Regulation - Draft Corporations Amendment Regulations – Explanatory Information*, which was issued in October 2005 and available on the Treasury web-site observes that:

'In relation to advice to switch from one superannuation fund to another, the 'from' fund does not constitute an alternate financial product considered but not recommended. ***Hence, in a super switching scenario, information about the 'from' fund would still need to be included in the SoA.****'* [emphasis added]

9.9 That is, the requirements of section 947D of the Corporations Act requires an outline of the implications of switching from one superannuation fund to another. This would be a 'significant consequence' for Bruce and Lynne taking Macquarie's proposed course of action / recommendation.

9.10 The Explanatory Memorandum which accompanied section 974D of the Corporations Act explained the purpose of the section as follows:

Additional requirements when advice recommends replacement of one product with another

12.57 Where a client is advised to replace an existing financial product, specific disclosures are required in the SoA to enable the client to assess the cost of replacing a product and the potential financial loss or loss of benefits that may result (proposed section 947D).

12.58 The objective of this requirement is to alert clients to the disadvantages as well as the advantages of acting on advice to replace an existing product. It is anticipated that this requirement will limit the potential for twisting and churning.

9.11 Further guidance with respect to superannuation 'switching advice' can be found in Australian Securities and Investments Commission (**'ASIC'**) Regulatory Guide 84, entitled *Super Switching Advice: Questions and Answers* (**'the Guide'**). The Guide defines 'super switching advice' at paragraph 1 as follows:

'Super switching advice' is not a technical or legal term. We use it in this document to refer to personal advice given to a retail client relating to either or both:

- *the transfer (in whole or part) of an existing super account balance from one super fund (the 'from' fund) to another super fund (the 'to' fund);*
- *the redirection of future contributions away from one super fund (the 'from' fund) to another super fund (the 'to' fund).*

9.12 The Guide distinguishes as between the 'to' superannuation fund (i.e. the fund that is being recommended by an advisor) and the 'from' superannuation fund (i.e. the fund that the client has an investment in, which will be withdrawn to go to the 'to' fund). Specifically, paragraph 5 of the Guide provides that '*Super switching advice requires you to consider both the 'to' and 'from' funds*'.

9.13 Paragraph 2 of the Guide provides that '*Advice that is only about choosing between various investment options or strategies within the one super fund is not super switching advice*'. Paragraph 2 then provides that:

Advice that only deals with your client's 'to' fund is not super switching advice. This is because it does not include any express or implied opinion or recommendation about your client' existing super. Two examples of 'to' fund advice are where a client:

- *changes jobs and can no longer contribute to their existing fund and wants advice only about an appropriate 'to' fund; or*
- *has already made up their mind to move from their existing fund and wants advice only about an appropriate 'to' fund.*

9.14 Paragraph 2 of the Guide also provides that:

Advice limited solely to comparing specific features of the 'from' fund and 'to' fund (eg fees and costs) without any express or implied recommendation to switch is not super switching advice. However, if you give such advice, in your SOA you should say that:

- *the advice is limited (in this example, to advice about comparative costs);*
- *the advice does not constitute a recommendation that your client should move to the 'to' fund; and*
- ***your client should consider moving to the 'to' fund only after considering the consequences of the change, which would generally include insurance implications, such as whether there would be an insurance gap***. [emphasis added]

9.15 ASIC considers the practical factors that should be considered when an advisor recommends a self-managed superannuation fund. It is observed that:

It will also be critical to consider your client's need for appropriate and affordable insurance cover. *Unless the SMSF trustees specifically take out insurance for fund members, there will be no cover. Experience shows that SMSF insurance is generally more expensive and harder to get than in larger funds.* [emphasis added]

9.16 For completeness, ASIC considers that a 'disclaimer' that provides that the 'from' fund will not be considered in the Statement may not be sufficient for the purposes of an advisor's obligations under the switching disclosure requirements. The Guide observes that:

A disclaimer that says "this is not advice about the 'from' fund" will not let you limit your consideration to the 'to' fund if the substance of your advice is or includes a recommendation to switch.

10 GUARANTEES AND 'INSTALMENT WARRANT' ARRANGEMENTS

10.1 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 TA 2008/5, 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.

(a) Overview of the regulatory regime

10.2 TA 2008/5 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.'*

10.3 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.

10.4 At paragraph 6 of the 'Description' section of the TA 2008/5, the Commissioner outlines a number of 'concerns' under subsection 67(4A) of the SIS Act arrangements, including that

10.4.1 the interest rate for the borrowing is zero or less than a commercial rate, particularly where the lender is a related party;

10.4.2 the interest rate for the borrowing exceeds a commercial rate, particularly where the lender is a related party

10.4.3 interest on the borrowing is able to be capitalised;

10.4.4 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

10.4.5 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).

10.5 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 TA 2008/5, 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…'*

10.6 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.

10.7 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 …*'.

(b) A guarantor's right of subrogation

10.8 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.

10.9 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.'* [25]

10.10 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.'*[26]

10.11 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:

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

> *'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 …"…'*

10.12 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 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.'*

10.13 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.'*

10.14 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).

(c) Right of subrogation is an equitable based right

10.15 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'.*

10.16 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 …*'.

(d) A surety's rights are new rights

10.17 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).[27]

[27] 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 '*A surety who has made payment of more than his due portion of the common liability is* ***entitled to have assigned to him all the creditor's rights and securities****, whether satisfied or not, for the purpose of obtaining contribution …*' [emphasis added]. However, those comments were in the context of co-contributions by sureties.

Rather, to the extent that the creditor's right has been extinguished, then the surety acquires new rights as against the debtor. (*Halifax Mortgage Services Ltd v Muirhead* (1998) 76 P & CR 418).[28]

(e) The scope of the surety's 'new' rights – replication of creditor's rights

10.18 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] …'.

10.19 The following propositions have been made with respect to a surety's right of subrogation:[29]

Number	Proposition
One	The surety's new rights inherit any defects of the creditor's original security interest.[30]
Two	The surety cannot exercise its subrogation rights such that it recovers a larger amount than the creditor could have recovered.[31]
Three	Any security interest that a surety acquires inherits the same priority as the creditor's security interest.[32]
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).[33]
Five	The surety cannot take action to enforce a right which could not have been enforced by the creditor.[34]

10.20 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:

> *'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.'*

10.21 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*

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[28] 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 '*… would respectfully say that Lord Hoffman's relation … of subrogation to unjust enrichment …* [in *Banque Financiere de la Cite v Parc (Battersea) Ltd*] *… is not established in Australian case law.*'

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

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

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

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

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

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

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.'

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

(f) Rights of a surety differ from creditor's rights

10.23 There are also authorities which illustrate when the rights of a surety may differ from the rights of a creditor:[35]

Number	Proposition
One	The Court may modify a surety's rights where the debtor (or another party) has successfully invoked a defense.[36]
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.[37]
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.

11 SPECIFIC ISSUES WITH SUBSECTION 67(4A) OF THE SIS ACT

11.1 As discussed above, subsection 67(4A) of the SIS Act arrangements may meet the definition of 'derivative' contained in section 761 D of the Corporations Act, and probably the definition of 'warrant' contained in regulation 1.0.02 of the Corporations Regulations. As a result, such arrangements should only be issued by an appropriately licensed issuer under an appropriate PDS.

11.2 So as to put the issue beyond doubt, subsection 67(4A) of the SIS Act should be amended so that either the term 'derivative' or 'warrant' be included in the subsection, with the definition of the term cross referenced to the Corporations Act (for derivative) or the Corporations Regulations (for warrants).

11.3 Given that 'warrants' cover a wider range of arrangements than 'derivatives' (see **paragraph 8.2** above), the better approach may be to have subsection 67(4A) of the SIS Act amended such that it captures 'warrant' arrangements as defined in regulation 1.0.02 of the Corporations Regulations. However, the requirement of transferability (as provided for in the 'warrants' definition) may be omitted.

11.4 For example, subsection 67(4A) may be amended so as to provide 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 a derivative ~~an arrangement~~ under which: ...'

11.5 The term 'derivative' would then be defined in subsection 10(1) of the SIS Act as:

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

> ***'Derivative** has the meaning given by section 761D of the Corporations Act 2001 (Cth).'*

11.6 Alternatively, subsection 67(4A) of the SIS Act may be amended by providing 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 a warrant ~~an arrangement~~ under which: ...'*

11.7 The term 'warrant' would then be defined in subsection 10(1) of the SIS Act as:

> ***'Warrant** has the meaning given by regulation 1.0.02 of the Corporations Regulations 2001 (Cth), except for the paragraph (b) of that definition'*

(a) Paragraph 67(4A)(a)

11.8 Paragraph 67(4A)(a) does not deal with money applied for the improvement and/or maintenance of an asset, such as the capitalization of interests and using borrowings to pay for stamp duty. This is an unnecessary limitation to the borrowings exemption. For example, in the event that expending funds to 'improve' an asset will cause a larger increase in the assets value (when compared to the amount borrowed to 'improve'), the investor should be able to make the choice to borrow to conduct the 'improvements'.

11.9 Further, superannuation funds may be subject to unnecessary losses in the event that they are forced to sell assets for which they do not have the financial capacity to improve.

11.10 Indeed, it is considered that the expansion of paragraph 67(4A)(a) to allow investors to use such arrangements to borrow to 'improve' or 'maintain' is consistent with the approach of not dictating the investments which a superannuation fund should acquire.

11.11 This section should also allow for a borrower to refinance as third party financiers may place undue pressure and restrictive terms on gearing arrangements knowing that a trustee of a superannuation fund cannot leave that financier after initial drawdown. Indeed, a trustee of a superannuation fund should be able to switch financiers (via refinancing) in order to protect their financial exposure and ensure that they are not forced to dispose of an asset in unfavourable circumstances.

11.12 Further, the term 'an asset' contained in this section is unnecessarily restrictive. This is because the diversification of the acquirable assets in a superannuation fund would reduce risks and maximise returns in the investment according to the 'modern portfolio theory. It is submitted that the proposed provisions do not encourage diversification of assets resulting in higher risks, is inconsistent with the policy behind superannuation savings.

11.13 Also, allowing a superannuation fund to borrow to acquire additional assets subject to these arrangements would allow a superannuation fund to Dollar Cost Average its exposure in particular arrangements.

11.14 The legislation should also allow for the acquisition by a superannuation fund of part of an asset. For example, the legislation should make it clear that a super fund can borrow to acquire interest in real property (for example as tenants in common). This allows a superannuation fund to obtain a partial interest in a property (subject to the arms' length provision already contained in the SIS Act) without obtaining an exposure with respect to all of the assets.

(b) Paragraph 67(4A)(b)

11.15 Paragraph 67(4A)(b) needs to define what a 'beneficial interest' is and how does a 'beneficial interest' arise given the application of the respective Trustee Acts in each States and Territories and issues such as the right of indemnity of the trustee. In particular, there is case law which suggests that a beneficiary cannot have a 'beneficial interest' whilst there is a trustee's right of indemnity (see also the respective State legislation – for example subsection 59(4) of the *Trustee Act* 1925 (NSW)).

11.16 Further, paragraph 67(4A)(b) also needs to deal with the interaction of 'beneficial interests' of the trustee and the competing security interests of some of the third party financiers with respect to

67(4A) arrangements. It is submitted that paragraph 67(4A)(b) should clarify whether the competing interests (i.e. the trustees interest and the security interests) will cause a superannuation fund / investor to not have a 'beneficial interest' in the acquirable asset.

(c) Paragraph 67(4A)(c)

11.17 It is submitted that paragraph 67(4A)(c) should specifically provide that the right to acquire legal ownership should only occur after the borrowings have been repaid. Otherwise, after one 'payment', the superannuation fund (i.e. investor) can call upon the legal title notwithstanding that the loan has not been repaid in full. The provisions should provide that the legal ownership can only be obtained by the superannuation fund / investor after the borrowings have been repaid.

(d) Paragraphs 67(4A)(d) and (e)

11.18 Paragraphs 67(4A)(d) and (e) need to make it clear that the sections extends to additional undertakings / warranties provided to financiers in the course (or in connection with) obtaining finance. This is because financiers generally require personal guarantees (and possibly implied indemnities) from members of the superannuation fund. In such cases unlimited recourse is obtained through the assets of the members (for example), and all that is occurring is a shifting in the liability. Given that the aim of the superannuation regime is to encourage and promote the growth of assets to for the purposes of the provision of a person's retirement, the legislative intention would be defeated by having personal guarantees if the 'net wealth position' of an individual is worse off after a default. That is, the intention of these arrangements is to shift the risk to the product issuers, and not the superannuation fund, or the members of the superannuation fund.

11.19 Further, it is noted that financiers often require undertakings from the superannuation fund in instalment arrangements. Therefore, it is questionable that in the event that the undertakings by the superannuation fund is breached, whether the third party financiers are entitled to call on more than the asset which has been acquired by the borrowing. This issue would be resolved by the expansion of these sections to include additional undertakings / warranties provided to financiers in the course of (or in connection with) obtaining finance.

(e) General comments

11.20 It is also submitted that there needs to be an extension of the 'knowingly concerned' / 'involved' provision currently contained in section 193 of the SIS Act so that it applies to subsection 67(4A) arrangements. That is, if financiers are 'knowingly concerned' in a contravention of the provisions, then they should also be subject to penalties / sanctions to prevent the third party financiers from taking an 'all care and no responsibility' approach with these arrangements.

12 IN-HOUSE ASSET ISSUES

12.1 Superannuation funds are, generally, not allowed to invest in a related party. Assets held by a superannuation fund may be in-house assets of the fund under subsection 71(1) of the SIS Act, which states:

> *'For the purposes of this Part,* ***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****, but does not include [a number of specified exceptions].'* [Emphasis Added]

12.2 This is important as section 83 of the SIS Act prohibits a superannuation fund from acquiring an in-house asset if the market value ratio of the fund's in-house assets exceeds 5%, or would exceed 5% if the asset was acquired, of the market value ration of all of the fund's assets.

12.3 There is, however, a main exception to this restriction. An investment in a related party is not an in-house asset provided certain conditions are satisfied. The reasoning of this exception is that many people use the premises from which their business is run as part of their retirement strategy: their business pays rent to their superannuation fund which owns the property.

12.4 Rather than owning the property itself it can be advantageous for the SMSFs to own units in a unit trust, which in turn owns the property. The advantage of this course is that the property can be renovated or further developed by the SMSF subscribing for more units in the unit trust. The trustee of the unit trust will use this subscription money for expenditure on the property. This development would not be permitted if the SMSF owned the property itself.

(a) History of Investments in Units by SMSF's

12.5 The decision of *Trevisan v FCT* (1991) 21 ATR 1649, makes it clear that an investment in units of a unit trust, even where the trustee of the unit trust is a standard employer sponsor, is not an in-house asset. This decision was based on the fact that an investment in units is not an investment in the trustee of the unit trust.

12.6 This interpretation led to the prevalent use of unit trusts as a way of a superannuation fund indirectly owning property that has been acquired using borrowings.

12.7 On 11 August 1999, major amendments were made to the superannuation investment rules. These amendments were introduced to overcome the decision in *Trevisan* that investments in related trusts were not in-house assets. The amendments led to the wording of subsection 71(1) stated above. After 11 August 1999, investments in related trusts will be in-house assets.

(b) Units in a Unit Trust

12.8 Shares in a related company or units in a related unit trust held by a fund are considered to be in-house assets of the fund if the company or trustee of the unit trust is a relate party, unless an exception applies to exclude the shares or units from being in-house assets of the Fund: see for instance paragraph 5 of *SMSFD 2008/2*.

12.9 One of the specified exclusions from the definition of in-house asset in subsection 71(1) is 'an asset included in a class of assets specified in the regulations: … not to be in-house assets of a class of funds to which the fund belongs': subparagraph 71(1)(j)(ii) of the SIS Act.

12.10 Sub-regulation 13.22C(2) of the SIS Regulations states the conditions that must be satisfied for the purposes of subparagraph 71(1)(j)(ii) in order for asset not to be an in-house asset of the superannuation fund. regulation 13.22D(1) of the SIS Regulations then provides a number of events that will cause regulation 13.22C to cease to apply to an asset, thereby removing that assets exemption from being an in-house asset.

12.11 Effectively, regulations 13.22C and 13.22D of the SIS Regulations impose the following conditions in order for an investment in a related unit trust not to be an in-house asset:

12.11.1 the superannuation fund has fewer than five members;

12.11.2 the trustee of the unit trust is not a part to a lease with a related party of the superannuation fund unless the lease relates to 'business real property' (basically real property used wholly and exclusively in one or more businesses);

12.11.3 the trustee of the trust does not have any outstanding borrowings;

12.11.4 the assets of the unit trust do not include:

(a) an interest in any other entity; or

(b) a loan to another entity other than money on deposit with a bank or lending institution; or

(c) an asset that is subject to a charge; or

(d) an asset that was acquired from a related party of the superannuation fund after 11 August 1999 (unless it was 'business real property');

12.11.5 the trustee of the unit trust must not conduct a business; or

12.11.6 the trustee of the unit trust conducts a transaction otherwise than on an arm's length basis.

12.12 The term 'business real property' in relation to an entity is defined in subsection 66(5) of the SIS Act to mean:

> *'(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 purposes 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.'*

12.13 It should be noted that if the conditions contained in regulations 13.22C and 13.22D are no longer satisfied, for instance the asset ceases to be 'business real property' because it is no longer used wholly and exclusively in one or more businesses, the unit holding in the unit trust will become an in-house asset from the time of the change.

13 GOODS AND SERVICES TAX IMPLICATIONS

13.1 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.'*

13.2 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*'.

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

13.4 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'?

13.5 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.'*

13.6 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.

13.7 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 … '.*

13.8 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.'*

13.9 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 instalment warrant 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.

13.10 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

13.11 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.

13.12 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).'*

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

13.13.1 the recipient of the supply (i.e. the 'purchaser') must be registered (or required to be registered);

13.13.2 the supply must be for consideration;

13.13.3 both parties have agreed in writing that the supply is of a going concern; and

13.13.4 the vendor must supply all things necessary for the continued operation of the enterprise.

13.14 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 ...*'.

13.15 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.

13.16 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.'*

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

13.18 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[38] and *Wellcomne Trust Limited v Commrs of Customs & Excise* [1996] 2 CMLR 909.

13.19 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.'*

13.20 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.

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[38] At paragraph 9, the European Court of Justice was asked to consider '… *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 …*'. The Court at paragraph 13 held that '*It does not follow … that the mere acquisition and holding of shares in a company is to be regarded as an economic activity … 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 property'*. We note that in the Warrant arrangement, the Security Trustee has no right to equivalent of the 'dividend yield' referred to by the ECJ in *Polystar*.

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

13.21 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 provide 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]

(d) Non-application of Subdivision 72-A of the GST Act

13.22 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:*
>
> *(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'.*

13.23 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:

13.23.1 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

13.23.2 trustees – *'… any entity that benefits under the trust …*' (see paragraph 318(3)(a) of the 1936 Act).

13.24 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:

13.24.1 the associate is not registered or required to be registered; or

13.24.2 the associate acquires the supply otherwise than solely for a taxable purpose.

13.25 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.'*

13.26 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.

14 STAMP DUTY

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

14.2 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**')).

14.3 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.

14.4 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

14.5 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.'

14.6 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*'.

14.7 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

14.8 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

14.9 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

14.10 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)*.

14.11 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.

14.12 Relevant Rulings:

14.12.1 Commissioner's Practice SD 3.0

14.12.2 Commissioner's Practice SD 28.0.

(e) Tasmania

14.13 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

14.14 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.

14.15 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

14.16 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

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

14.18 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.

14.19 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.

15 NEW SOUTH WALES LAND TAX

15.1 Generally speaking, the liability (and exemptions) to pay land tax in New South Wales is assessed under the *Land Tax Management Act 1956* (NSW) (**'LTM Act'**). Imposition and the applicable land tax rates is provided for in the *Land Tax Act 1956* (NSW) (**'LT Act'**).

(a) Overview of the New South Wales land tax provisions

15.2 Section 7 of the LTM Act is the central charging provision, under which land tax is to be levied and paid on the land value of all land situated in New South Wales which is owned by taxpayers. Section 7 of the LTM Act provides that:

> *'Land tax at such rates as may be fixed by any Act is to be levied and paid on the taxable value of all land situated in New South Wales which is **owned** by taxpayers (other than land which is exempt from taxation under this Act).'* [emphasis added]

15.3 The charge to land tax is in respect of lands owned at midnight on 31 December immediately preceding the year for which the land tax is levied. Section 8 of the LTM Act provides that:

> *'Land tax shall be charged on land as **owned** at midnight on the thirty-first day of December immediately preceding the year for which the land tax is levied.*
>
> *In this section year means the period of twelve months commencing on the first day of January*.' [emphasis added]

15.4 For example, land tax for the year commencing 1 January 20010 is leviable and payable in respect of land owned as at midnight on 31 December 2009.

15.5 In general, the principal place of residence and land used for primary production is exempt from land tax. Properties potentially liable for land tax therefore include:

15.5.1 vacant land, including vacant rural land;

15.5.2 a holiday home;

15.5.3 investment properties;

15.5.4 company title units; and

15.5.5 commercial, residential and industrial units.

(b) Who is an 'Owner' for NSW land tax purposes

15.6 Essential in determining land tax liability is ascertaining the 'owner' of land. This is because it is the 'owner' of the land who is subject to land tax (section 7 of the LTM Act).

15.7 The term 'owner' is defined in subsection 3(1) of the LTM Act, as being:

15.7.1 in relation to land, every person who jointly or severally, whether at law or in equity:

- is entitled to the land for any estate of freehold in possession; or
- is entitled to receive, or is in receipt of, or if the land were let to a tenant would be entitled to receive, the rents and profits thereof, whether as beneficial owner, trustee, mortgagee in possession, or otherwise;

15.7.2 in relation to any leasehold estate in land, whether legal or equitable,39 a person, or a persons who is a member of a class or description of persons, prescribed for the purposes of the provisions; or

15.7.3 a person who, by virtue of the LTM Act, is deemed to be the owner.

(c) Instalment warrant arrangements and land tax

15.8 The issue of whether a trustee of a bare trust is an 'owner' under the LTM Act was considered in *Opalfield Pty Ltd v Commr of Land Tax (NSW)* 93 ATC 4863, where Sully J found that a shelf company that was no more than a bare trustee of the property was not an 'owner' within the definition of that term in section 3(1)(a)(i) of the LTM Act. The decision was subsequently overturned on appeal, however the interpretation of 'owner' by Sully J was not addressed by the Court of Appeal.

15.9 The issue was revisited by the NSW Court of Appeal in *Chief Commr of Land Tax v Macary Manufacturing Pty Ltd* 2000 ATC 4001 and it was held by Mason P (with whom the Spigelman CJ, and Sheller JA agreed) that:

> *'63. In my respectful view Sully J in Opalfield and Black AJ in the present case elided two distinct legal concepts and, in so doing, erred when they held that a bare trustee does not fit within par (a) of the definition of ``owner'' because it has no present right of beneficial enjoyment. A trustee of the entire fee simple (ie where no future interest is involved) holds an estate in possession whether the trust is bare or active. It is beneficial in that (common law) sense. The legal estate confers a legal right to enjoyment or possession of the land and its rents and profits, even though the trustee may be compelled to hold that right for the benefit of the beneficiary. See also Kern Corporation Ltd v Walter Reid Trading Pty Ltd & Ors (1987) 4 ANZ Insurance Cases ¶60-790 at 74,834; (1987) 163 CLR 164 at 191-192 (Deane J).'*

15.10 Mason P then went on to distinguish *Opalfield* and observed that:

> *'67. Similar reasoning leads to the conclusion that the Trustee was also an owner because, ``if the land were let to a tenant [it] would be entitled to receive the rents and profits thereof... as trustee'' within sub-par (ii) of par (a) of the definition of "owner".*
>
> *68. Nothing in the definition of ``owner'' in s 3(1) suggests that there can only be one taxable owner of land at any point of time. Indeed, there are overwhelming indications to the contrary, because of the words ``every person... whether at law or in equity'' and because of the group of persons deemed to be owners by virtue of par (d) of the definition.*
>
> *69. A trustee is answerable as a taxpayer, obliged to submit returns and armed with various rights (s 64). Section 24 provides that any person in whom land is vested as a trustee shall be assessed and liable in respect of land tax as if beneficially entitled to the land. The owner of an equitable estate or interest is also liable as if he or she were the legal owner (s 25). Several provisions of the Management Act contemplate multiple taxable ``owners'' in respect of the same land at the same time (see ss 23, 24, 25, 26, 27, 30, 32). Double taxation is avoided through recognition of ``primary'' and ``secondary'' taxpayers, with the secondary taxpayer being entitled to a deduction for such amount (if any) as is necessary to prevent double taxation. As between the legal and equitable owner, the owner of the legal estate is deemed to be the primary taxpayer (s 25). However, that owner's rights of recoupment, retention and indemnity are recognised by s 64.'*

15.11 That is, both the trustee and the beneficiaries of a bare trust would be an 'owner' for the purposes of the LTM Act. As a result of the definition of 'owner' under the LTM Act, land tax will need to be considered by trustees of superannuation funds when they invest in real property via subsection 67(4A) of the SIS Act.

15.12 A trustee of a superannuation fund will be investing in a trust relationship when entering into a subsection 67(4A) of the SIS Act arrangement, and will acquire a 'beneficial interest' in the property the subject of the arrangement. As a result, the entity that holds the property (ie, the security trustee) will be required to lodge a land tax return, and the primary / secondary land tax liability

[39] Except for lessees of land owned by the Crown or council (section 21C of the LTM Act) or lessees of leasehold strata lots (section 21D of the LTM Act).

provisions will apply as between the security trustee, and the trustee of the self-managed superannuation fund.

15.13 The treatment of trusts that hold New South Wales situated land for land tax purposes depends on whether they are characterised as 'special trusts' or not. Land which is subject to a trust other than a 'special trust' can access the land tax-free threshold, which is $380,000 for the 2009 and 2010 land tax year of the 'taxable value'. However, if a trust is a 'special trust' and the land tax-free threshold does not apply.

(d) Definition of 'special trusts'

15.14 A trust will be a 'special trust' if:

15.14.1 it falls under the definition of 'special trusts' in section 3A of the LTM Act; or

15.14.2 the Commissioner classifies the trust as a 'special trust' under section 25A of the LTM Act either on its own motion or on the application of the trustee of the trust.

15.15 Subsection 3A(1) of the LTM Act defines a 'special trust', by providing that '*… a trust is a* ***special trust*** *if…':*

15.15.1 the trust property includes land;

15.15.2 the trustee of the trust is the owner of the legal estate in the land; and

15.15.3 the trust is not a '**fixed trust**'.

15.16 There are also specific carve-outs from the definition of 'special trusts' in subsection 3A(4) of the LTM Act in respect of certain types of trusts such as charitable trusts, family unit trusts, and superannuation trusts.

15.17 Subsection 3A(2) of the LTM Act provides that for the purposes of section 3A of the LTM Act, a trust is a 'fixed trust':

> '…*if* ***the equitable estate in all of the land that is the subject of the trust is owned by a person or persons*** *who are owners of the land for land tax purposes* (disregarding *section* 25(3)[40])'. [emphasis added]

15.18 Subsection 3A(3) provides that for the purposes of determining whether a trust is a fixed trust, '*… any equitable interest of the trustee as trustee of the trust is to be disregarded…*'.

15.19 Further, subsection 3A(3A) provides when a trust is taken to be a fixed trust:

> *(3A)* ***If a trust satisfies the relevant criteria****, the persons who are beneficiaries of the trust under the trust deed are taken to be owners of an equitable estate in the land that is the subject of the trust and, accordingly, the trust is taken to be a fixed trust.* [emphasis added]
>
> ***Note****. Under section 25, owners of an equitable estate or interest in land are liable in respect of land tax as if they were legal owners of the land. Owners of an equitable estate in land are treated as secondary taxpayers.*

15.20 The 'relevant criteria' described in subsection 3A(3A) are set out in subsection 3A(3B) as follows:

> *(a) the trust deed specifically provides that the beneficiaries of the trust:*
>
> *(i) are presently entitled to the income of the trust, subject only to payment of proper expenses by and of the trustee relating to the administration of the trust, and*
>
> *(ii) are presently entitled to the capital of the trust, and may require the trustee to wind up the trust and distribute the trust property or the net proceeds of the trust property,*

[40] Subsection 25(3) of the LTM Act provides a carve-out to the extent that the land is subject to a 'special trust'.

(b) the entitlements referred to in paragraph (a) cannot be removed, restricted or otherwise affected by the exercise of any discretion, or by a failure to exercise any discretion, conferred on a person by the trust deed.

15.21 That is, in order for a subsection 67(4A) arrangement to be considered a 'fixed trust' and therefore not caught by the definition of 'special trust' contained in section 3A of the LTM Act, the equitable estate in all of the land that is the subject of the subsection 67(4A) arrangement needs to be 'owned' by the Investor. That is, the land needs to be subject to a 'fixed trust' – which is one in which the Investor have an indefeasible interest in the trust fund.

(e) Holding land in a trust – the secondary liability provisions

15.22 Under the LTM Act, trustees are primarily liable for land tax, with beneficiaries of fixed trusts secondarily liable. Section 24 of the LTM Act provides that:

'Any person in whom land is vested as a trustee shall be assessed and liable in respect of land tax as if he or she were beneficially entitled to the land:

Provided that where he or she is the owner of different lands in severalty, in trust for different persons who are not for any reason liable to be jointly assessed, the land tax so payable by the person shall be separately assessed in respect of each of those lands:

Provided also that when a trustee is also the beneficial owner of other land, he or she shall be separately assessed for that land, and for the land of which he or she is a trustee, unless for any reason he or she is liable to be jointly assessed independently of this section.'

15.23 Further, subsections 25(1) and (2) of the LTM Act provides that:

*'(1) The **owner of any equitable estate or interest in land** is liable in respect of land tax **as if he or she were the legal owner of the estate or interest** and land tax is to be assessed accordingly.*

(2) For that purpose:

*(a) the **owner of the legal estate is taken to be the primary taxpayer** and the **owner of the equitable estate is taken to be the secondary taxpayer**, and*

(b) there is to be deducted from the land tax payable by the secondary taxpayer in respect of the land such amount (if any) as is necessary to prevent double taxation.' [emphasis added]

15.24 That is, the trustee of a fixed trust is subject to a primary assessment with respect to land tax. A beneficiary of a fixed trust is also liable for land tax on their proportionate entitlement to the land subject to the fixed trust, but the beneficiary obtains a deduction from the amount of land tax payable with respect to land held in a fixed trust to the extent that the tax is paid by the trustee of the fixed trust. The result is that land tax with respect to land held subject to a fixed trust is paid once.

15.25 However, subsection 25(3) of the LTM Act provides that the primary / secondary liability mechanism contained in subsection 25(2) of the LTM Act '*… does not apply in respect of land that is subject to a special trust*'. Therefore it is important to ensure that any subsection 67(4A) arrangements under which land will be acquired would not fall within the definition of 'special trusts' under the LTM Act.

