13 February 2015

Tania Koit
Tax Counsel Network
Australian Taxation Office
52 Goulburn St
Sydney NSW 2000

Via Email: instalmentwarrants@treasury.gov.au

Dear Ms Koit,

Look-Through Treatment for Instalment Warrants and Instalment Receipts

The Australian Financial Markets Association (AFMA) represents the interests of over 130 participants in Australia's wholesale banking and financial markets. Our members include Australian and foreign-owned banks, securities companies, treasury corporations, traders across a wide range of markets and industry service providers. Our members are the major providers of services to Australian businesses and retail investors who use the financial markets.

AFMA is pleased to provide comments in relation to the Exposure Draft (**ED**) and accompanying draft Explanatory Memorandum (**EM**) that provide look-through treatment for holders of instalment warrants and instalment receipts. In framing our submission, we are conscious of the ATO, as opposed to Treasury, taking the lead in terms of legislative design. We acknowledge that the ambit of the consultation is merely to give effect to the announcements by former Assistant-Treasurers Sherry and Shorten from 2010, that is, to provide look-through only for those instruments where the underlying investment is a listed or widely-held. We note for completeness that there does not appear to be a compelling reason, from a policy perspective, to restrict look-through treatment to only assets of a certain class and accordingly we reserve the right to seek further legislative clarity in due course.

The structure of the ED and draft EM is to limit the scope of the assets to which look-through treatment is possible to shares, units and stapled securities. Technically, this is not consistent with the policy scope as articulated in 2010, which refers to, as per Senator Sherry's Media Release of 10 March 2010, the scope of eligible assets as being "a single exchange traded security in a company, trust or stapled entity" (later extended to widely-held). The ambit of the term "security" is broader than merely shares, units

and stapled securities and may also include, based on the definition in Chapter 7 of the Corporations Act, options, debentures, managed investment products and other legal/equitable rights. Accordingly, we submit that the scope of underlying investments capable of an instalment trust asset refer to the Corporations Act definition of "security" as opposed to shares, units or stapled securities.

We further note that the ATO has yet to finalise Draft Taxation Ruling TR 2004/D25 that addresses the circumstances where an investor will be considered to be absolutely entitled to an asset for capital gains tax purposes. This is an area of tax administration that is ripe for additional guidance and we will be engaging with the ATO both with respect to the finalisation of this Draft Ruling and also to extend the ambit of the principles of absolute entitlement, and the circumstances in which it is conferred, to other areas of the law.

Limited Recourse Requirement

As currently drafted, in order for an instalment warrant trust to be eligible for look-through treatment, it is necessary that the instalment warrant arrangement meets the limited recourse requirements in proposed Sub-Sections 235-830(2) and (3). Effectively, these proposed sub-sections require that the rights of the lender against the investor are limited to default on the borrowing, plus other charges, and that the underlying investment should not be subject to any additional charges or encumbrances. We note that these sections only relate to non-superannuation fund investors.

We submit that there is no rationale for the existence of the limited recourse requirements to be included in the proposed legislation and request that they be excised from the ED. We are of this view for the following reasons:

- There are no limited recourse requirements in respect of instalment receipt trusts in proposed Section 235-835 and hence there would be different requirements to be met for what are essentially economically fungible investments;
- The regulatory capital treatment for limited recourse loans has changed, such that the preference for issuers of instalment warrant-style products is to issue loans on a full-recourse basis with explicit protection (such as an explicit put option), meaning that the limited recourse requirement will be more difficult to adhere to for identical products (i.e. products for which there was a market in 2010);
- The limited recourse requirement is understood to have been included so as to allow for compliance with the requirements for complying superannuation entities under Section 67A of the *Superannuation Industry (Supervision) Act* (the **SIS Act**), and hence to the extent that there is a limited recourse requirement for such investors, it is better placed in the SIS Act. This is particularly the case given that the policy rationale for Section 67A of the SIS Act is to protect other superannuation fund assets and hence is not relevant to the income tax treatment of the warrant holder; and

- There is a proposed specific section that deals with investments by complying superannuation entities (proposed Section 235-840) and hence there is no relevance for the limited recourse requirements in proposed Section 235-830 for such entities.

We are of the view that there is no requirement for the borrowing to be limited recourse to give effect to the 2010 government announcements which define the policy scope.

For completeness, we note that to the extent that the limited recourse requirement was to remain, there are issues associated with the particular requirements in proposed Section 235-830(3), insofar as there may be additional charges, liens or other encumbrances on the other asset both at the investor level (such as an additional charge for TFN/ABN withholding amounts outstanding) and also at the trustee level.

Other Assets of the Instalment Trust

Proposed Section 235-825 allows for an asset to be an "instalment trust asset" only if "each asset, that is, or is part of, the underlying investment of the trust" is either a listed or widely held share, unit in a unit trust or stapled security or an interest in a trust that holds such assets. We note our comments above in relation to the appropriateness of this scope.

We note that there is the potential, by virtue of corporate actions payable on the underlying security, for other assets to fall within the trust, including cash and other property distributed by way of, for example, in-specie distributions. We submit that the existence of such assets should not, of themselves, cause the trust not to be an instalment trust and hence ineligible for look-through treatment. We submit that this issue can be addressed by including in Section 235-825(2) assets arising from corporate actions arising on the underlying investments as being included as eligible as instalment trust assets.

Definition of "Widely-Held"

As currently drafted, the widely-held requirement in proposed Section 235-825(2)(b)(ii) borrows from the Section 995-1 definition of a widely-held company and the Division 247 definition of a widely held unit trust.

The widely held unit trust definition was inserted into Schedule 2F of the 1936 Act in 1998 and is used for the purpose of applying the capital protected borrowing rules in Division 247 of the 1997 Act, as it relates to non-listed units from 1 July 2007. This definition, broadly, defines a trust to be widely held if it is not closely held, with a trust being closely held where 20 or less individuals, on associate inclusive basis, directly or indirectly holding more than 75% of the fixed entitlements to the capital or income of the trust.

Various issues have arisen with the application of this definition in the context of trusts, including difficulty adhering to the requirements in the start-up and wind-down phases and also tracing through intervening layers of widely held entities. In recognition of these practical difficulties, the definition of a "widely-held" trust in the Managed

Investment Trust (**MIT**) rules was amended in 2010. The resulting definition in Section 12-402 of the Taxation Administration Act, in AFMA's view, is more comprehensive and addresses a number of the practical difficulties associated with the Schedule 2F definition and accordingly should be considered as superseding the Schedule 2F definition.

Accordingly, we would advocate that, for the purpose of Item 2 in the Table in proposed Section 235-825(2)(b)(ii), the widely held test for MIT purposes be applied as opposed to that in Schedule 2F.

Clarification – "Benefit of Any Distribution"

Both Section 235-830(1)(b)(iv) (in respect of instalment warrants) and Section 235-835(b)(iv) (in respect of instalment receipts) require that the arrangement be one in which the investor is "entitled to receive the benefit of any distribution or non-share distribution made in respect of the underlying investment."

Concerns have been raised that arrangements where the investor agrees to "pay away" the benefit of such distributions, such as under a total return swap, will mean that the investor does not have the benefit of the distribution. As we believe that this is not the intention of the proposed sections, we request that the issue be clarified by way of a statement in the EM.

Clarification of "Vests in the Trustee"

There are a number of ways that an instalment warrant and instalment receipt may be created, including an investor transferring legal title to the underlying investment to the trustee to secure a borrowing, or a trustee using borrowed funds to acquire the underlying investment directly, such that legal title to the underlying investment does not sit with the investor prior to the creation of the warrant/receipt. In the latter circumstances, there is a concern that the asset does not "vest in the trustee" for the purpose of proposed Section 235-830(1)(a). This should be made clear in the EM.

Section 26BC Securities Lending Arrangements

AFMA has previously submitted that the ability of the trustee in an instalment warrant or instalment receipt trust to lend out the underlying securities under a Section 26BC complying securities lending arrangement should not, of itself, render the investor ineligible for look-through treatment. In such circumstances, the securities lending arrangements may reduce the cost of the warrant to the investor, due to a reduction in the cost of funds, without materially affecting the investor's entitlements.

Accordingly, we recommend that it be made clear, preferably in the ED, that the entry into Section 26BC compliant securities lending arrangements by the trustee does not affect the eligibility of the investor for look-through treatment.

Right to Acquire Legal Ownership

Proposed Section 235-830(i)(b)(iii), in relation to instalment warrants, and Section 230-835(i)(b)(iii), in relation to instalment receipts, require that the investor has a right to acquire legal ownership of the underlying investment having discharged obligations relating to the borrowing. Two issues arise from this requirement.

Firstly, it is not abundantly clear whether other amounts owing that have arisen under the investment, such as TFN/ABN withholding which remain unpaid, and will accordingly preclude the investor from demanding legal title, will be included as an "obligation relating to the borrowing." This should be made clear, both by amending the requirement from "obligation related to the borrowing" to "obligation related to the arrangement" and also by confirming language in the EM.

Secondly, in relation to offshore securities, the issuer of the warrant may require the investor to provide operational details in order to allow for transfer of legal title, such as custodian details or details of an omnibus account through which transfer will be effected. The EM should make it clear that the requirement to adhere to operational requirements will not fetter the investor's right to acquire legal ownership.

Application to CHESS Depositary Interests

AFMA notes the existence, in an Australian context, of "CHESS Depositary Receipts" (**CDIs**), which are defined by the ASX as a financial product which is a unit of beneficial ownership in an underlying financial product, which is held elsewhere, such as in a depositary. CDIs are generally used where the underlying residence of the security is a jurisdiction that does not recognise electronic registration as legal title. Accordingly, legal title is held by a separate entity, with beneficial title sitting with the holder, such that all economic benefits associated with the foreign securities are enjoyed by the holder. We note that, following on from the comments above on the ambit of the ED, a CDI would be considered to be a "security" for the purposes of the Corporations Act.

It is unclear to AFMA, based on a reading of the ED and draft EM, whether CDIs that are listed or widely held would be eligible for look-through treatment given the CDI is not, from a legal title perspective, a share, a unit or a stapled security. However, we note that a capital protected loan deployed to acquire a CDI will be subject to Division 247.

Given such uncertainty, and noting our comments regarding the scope of eligible instalment trust assets above, we request that instalment warrants and instalment receipts over CDIs specifically be noted as eligible for look-through treatment, by ensuring that the "underlying investment" to which Section 235-825 applies is beneficial title to that underlying investment. In recommending this amendment, we note that there may be other circumstances where there is a bifurcation of legal and beneficial title to the underlying investment that are similarly rendered eligible for look-through treatment.

Underlying Investment Ceases to be Eligible

As noted above, in order for an instalment warrant or an instalment receipt to be eligible for look-through treatment, it is necessary that the underlying investment be, subject to Section 235-825(2)(b), either listed on an approved stock exchange or meet the applicable widely held requirement.

The section does not appear to have any temporal requirement, and we note the possibility that underlying investments change their status, such as ceasing to be widely held or being de-listed. These will be matters beyond the control of the investor and should not, *ceteris paribus*, render the investment ineligible for look-through treatment.

Further, it is unclear to AFMA, to the extent that look-through treatment was no longer available, whether this would crystallise a CGT event or a re-commencement of the testing period for qualified person purposes.

Accordingly we submit that the test for eligibility for look-through treatment occur at the inception of the investment and there is no requirement for continuous testing.

Commencement

We note the effect of the transitional provisions, and particularly proposed Section 235-810, is to set commencement of the provisions with reference to assets that vest in a trust from the 2007-08 income year. This approach differs to that announced by Assistant Treasurers Sherry and Shorten in 2010, which states commencement with reference to assessments for the 2007-08 and later income years. Given that there are products that have been issued prior to 2007 that remain on foot, the change in approach in terms of commencement is of concern given that no legislative certainty arises for assessments post the 2007-08 income years that relate to such products.

We would advocate either a change in the transitional provisions, potentially to cover both assessments and the vesting of assets from the 2007-08 income year, or alternately a statement in the EM, coupled with an administrative statement from the ATO, that the industry practice in terms of the taxation treatment of instalment warrants and instalment receipts will be respected.

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Thank you for the opportunity to contribute to the ED and draft EM. Please let me know of any queries.

Yours sincerely,

Rob Colquhoun