

From 24 September 2007, self managed superfunds will be permitted to borrow to invest through an instalment warrant type arrangement - subject to certain conditions.

Up until 24 September 2007, superfunds were not permitted to borrow to invest. The borrowing prohibition is one of a number of rules put in place to limit the risk in superfund investment.

From 24 September 2007, the new sub-section 67(4A) of the *Superannuation Industry (Supervision) Act* (SISA) will allow a self managed superfund (SMSF) to borrow, but the borrowing must be in accordance with an arrangement that satisfy the new sub-section.

THE BORROWING RULES

Borrowings must be 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 superfund trustee receives a beneficial interest and a right (but not an obligation) to acquire the legal ownership of the asset through the payment of instalments,
- the lender's recourse against the superfund 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 (these rights may include taking possession of, or disposing of, the asset), and
- the asset must be one that the superfund trustee is permitted to acquire and hold directly (eg, real property, works of art in certain circumstances or listed securities). The existing investment restrictions, such as those on in-house assets and acquiring certain assets from a related party of the fund, continue to apply.

In addition, new sub-sections 71(8) and (9) of the SISA exclude an investment in a related trust forming part of the borrowing arrangement which meets the requirements of sub-section 67(4A) as in-house asset unless the underlying asset would itself be in-house asset of the fund if it was held directly.

This means that where an asset is held on trust (as required by the instalment warrant arrangement) by a trustee that is a related party, the arrangement will not automatically be an in-house asset.

WHAT IS INSTALMENT WARRANT?

Instalment warrants are a derivative-based investment product, in that they derive their value from the underlying asset. It is a contractual agreement, with a right but not an obligation, to buy the underlying asset through the payment of instalments. The investor have a beneficial interest in the underlying asset with a security interest held by the issuer that secures the payment of later instalments.

WHAT PROMPTED THE CHANGE?

Section 67 of the SISA prohibits trustees of superfund from borrowing to invest (limited borrowing was permitted, primarily relating to short term liquidity). It was deemed necessary to limit the risk in superfund investment.

Over the years, 'instalment warrants' became a common investment for superfunds, including SMSF. However, in 2006, the regulators (Commissioner of Taxation responsible for regulating SMSF and the Australian Prudential Regulation Authority responsible for regulating other superfunds) determined that instalment warrants comprised a component of borrowing and investment in these products by superfund is a breach of the SISA. As expected, the determination put the market in a state of confusion.

The Government recognised that the practice of superfund investing in instalment warrants is long standing and widespread and as such, allowed a reprieve until it legislate to allow the continued investment in these products. In order to avoid any disruption to the markets, the regulators have advised that, pending the law change, superfunds investing in traditional instalment warrants will not be considered to be non-complying under the SISA merely because of their investment in those products.

The new sub-section 67(4A) come into effect 24 September 2007. Although the heading of the sub-section is "Exception – instalment warrants", the actual working of the new sub-section is much wider and includes other borrowings as long as the conditions of the sub-section are satisfied. However, superfund trustees are still required to demonstrate the appropriateness of including instalment warrant type investments in their investment strategy.

SUMMARY OF CHANGES

New law	Old law
Sub-section 67(4A) of the <i>Superannuation Industry (Superannuation) Act</i> provide an exception to the borrowing prohibition for borrowings that meet certain conditions.	Section 67 of the <i>Superannuation Industry (Superannuation) Act</i> prohibits superannuation fund trustees from borrowing money except in limited circumstances, mainly related to short-term liquidity.
Sub-section 71(8) and (9) of the <i>Superannuation Industry (Superannuation) Act</i> provide that an investment in a related trust forming part of a borrowing arrangement which meets the requirements of sub-section 67(4A) will only be an in-house asset where the underlying asset would itself be an in-house asset of the fund if it were held directly.	Section 71 of the <i>Superannuation Industry (Superannuation) Act</i> defines 'in-house assets' to include an investment in a related trust of the fund.

Adopted from the *Explanatory Memorandum*

NOTES

The changes were introduced by *Tax Laws Amendment (2007 Measures No. 4) Act 2007*. The sub-section 67(4A) as made:

Exception - instalment warrants

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

- (a) the money is or has been applied for the acquisition of an asset (the original asset) other than one the RSF trustee is prohibited by this Act or any other law from acquiring; and
- (b) the original asset, or another asset (the replacement) that:
 - (i) is an asset replacing the original asset or any other asset that met the conditions in this subparagraph and subparagraph (ii); and
 - (ii) is not an asset the RSF trustee is prohibited by this Act or any other law from acquiring;is held on trust so that the RSF trustee acquires a beneficial interest in the original asset or the replacement; and
- (c) the RSF trustee has a right to acquire legal ownership of the original asset or the replacement by making one or more payments after acquiring the beneficial interest; and
- (d) the rights of the lender against the RSF trustee for default on the borrowing, or on the sum of the borrowing and charges related to the borrowing, are limited to rights relating to the original asset or the replacement; and
- (e) if, under the arrangement, the RSF trustee has a right relating to the original asset or the replacement (other than a right described in paragraph (c)) - the rights of the lender against the RSF trustee for the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the original asset or replacement.

The sub-sections 71(8) and (9) as made:

Limit on when investments in related trusts are in-house assets

(8) If, at a time:

- (a) an asset (the investment asset) of a superannuation fund is an investment in a related trust of the fund; and
- (b) the related trust is one described in paragraph 67(4A)(b) in connection with a borrowing, by the trustee of the fund, that is covered by subsection 67(4A); and
- (c) the only property of the related trust is the original asset or replacement described in that subsection;

the investment asset is an in-house asset of the fund at the time only if the original asset or replacement described in subsection 67(4A) would be an in-house asset of the fund if it were an asset of the fund at the time.

(9) Subsections (1), (2) and (4) have effect subject to subsection (8).

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