

Explanatory Memorandum – Instalment Warrants & the Capital Gains Tax problem.

One of the most overlooked issues involving instalment warrants is the capital gains tax consequences where the beneficiary of the warrant (the trustee of a self managed superannuation fund) is not absolutely entitled as against the custodian (the trustee of the warrant trust). A capital gain is triggered when a beneficiary becomes absolutely entitled as against the trustee to a CGT asset (sec. 104-75 ITAA97).

Many warrant trusts developed to comply with the new superannuation borrowing provision, sec 67(4A) of the SIS Act, contain clauses that mean the beneficiary (the trustee of the self managed superannuation fund) is NOT absolutely entitled to the asset as against the custodian immediately. The majority of warrant trust deeds contain a clause to the effect that the trustee of the SMSF can call upon the custodian to transfer the property only after the repayment of any loans made to the trustee of the SMSF. Such a clause will result in a capital gain being derived following the final payment of the loan taken out by the trustee of the SMSF.

Warrant Trust Deeds

In terms of complying with section 67(4A) of the Superannuation Industry (Supervision) Act the asset acquired by the trustee of an SMSF has to be held on trust. The trustee of the SMSF must acquire a beneficial interest in the asset and must also have the right to acquire legal ownership after one or more payments. Therefore the asset, usually being property, has to be held on terms of a trust, but the SIS Act does not require that the SMSF trustee's right to acquire legal ownership after one or more payments be part of the term of the trust. It is sufficient if the SMSF trustee has that right as a result of the mortgage arrangements.

The majority of warrant trust deeds, however, contain a clause that prevents the trustee of the SMSF from requesting a transfer of the legal ownership from the custodian until such time as the loan is repaid to the bank or financial institution. In effect the trustee of the SMSF is prohibited by the terms of the warrant trust deed itself from gaining legal title until such time as the loan is repaid.

A number of examples of such clauses appear below:

“The Property Trustee will transfer the legal title to the Beneficial Owner upon request after payment in full of any financial accommodation secured by the Property.” [National Law Firm]

“The PCT Trustee will offer to transfer the legal title to the Underlying Property to the SMSF Trustee upon request from SMSF Trustee and after payment in full, to the lender, of any financial accommodation secured by the Underlying Property.” [Shelf Company Provider]

“The Beneficiary may at any time after the Deed Date, by Notice to the Trustee, require the Trustee to transfer the legal title and estate in the Property to the Beneficiary but only if:

(b) all Loans have been repaid or discharged by the Beneficiary...”

[Shelf Company Provider]

The SIS Act does not require that clauses of the above kind be contained within the warrant trust deed. Where (as is usually the case) a lender has a registered first mortgage over the property and the property is registered in the name of the custodian, the SMSF trustee has the right to obtain legal ownership by paying of the loan because, at this point, there is nothing to stop the SMSF trustee from registering a transfer in its favour from the custodian.

The CGT Provisions

The term 'absolute entitlement' is not defined in the Income Tax Legislation (i.e. ITAA36 or ITAA97). Where a beneficiary becomes absolutely entitled to a CGT asset of a trust as against the trustee CGT event E5 applies (sec 104-75 ITAA97).

The Commissioner outlined his views on absolute entitlement in TR2004/D25. The most important part of the ruling is contained in paragraph 10 under the heading Core principle which states:

"10. The core principle underpinning the concept of absolute entitlement in the CGT provisions is the ability of a beneficiary, who has a vested and indefeasible interest in the entire trust asset, to call for the asset to be transferred to them or to be transferred at their direction..... The relevant test of absolute entitlement is not whether the trust is a bare trust...."

The beneficiary has to be able to call for the asset to be transferred to it. If it is unable to do this then until such time as it has that right the beneficiary is not absolutely entitled to the asset as against the trustee.

If a mortgage exists over the property the Commissioner has indicated at paragraph 62 of TR 2004/D25 that the beneficiary may still be absolutely entitled because:

"62. On the same basis, it is considered that the existence of a mortgage, encumbrance or other charge over the asset in favour of a third party with no interest in the trust does not of itself prevent a beneficiary being absolutely entitled to the asset as against the trustee.

This is because the existence of such a charge does not prevent the trustee from 'stepping aside' and, for example, transferring the asset to the beneficiary subject to the charge. That is, such a charge does not affect the beneficiary's relationship with the trustee."

Therefore, as long as the trustee of the SMSF can demand a transfer from the custodian (the warrant trustee) then the trustee of the SMSF will be absolutely entitled to the CGT asset against the custodian even if the SMSF trustee cannot immediately register the trustee because of the existence of the first mortgage.

If a clause in the warrant trust deed prevents the trustee of the SMSF from demanding a transfer from the custodian until the loan is repaid then the trustee of the SMSF will become absolutely entitled following the repayment of the loan, and a CGT event will occur at that time.

Kafataris v FC of T [2008] FCA 1454

The decision in Kafataris v DC of T supports the Commissioner's view in TR2004/D25. In fact, following the judgment, the ATO said that "we consider that the approach taken by Lindgren J aligns with the 'core principle' adopted in the ruling at paragraph 10. His Honour concluded that the test for absolute entitlement 'is intended to describe a situation in which the beneficiary of a trust has a vested, indefeasible and absolute interest in trust property and is entitled to require the trustee to deal with the trust property as the beneficiary directs' (paragraph 61)."

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