6 March 2020

Ms Jenny Wilkinson
Division Head
Retirement Income Policy Division
The Treasury
Langton Crescent

PARKES ACT 2600

By email: superannuationobjective@treasury.gov.au

Dear Ms Wilkinson,

Recommendation to Deregulate an Ineffective Superannuation Rule

We the Society of Trust & Estate Practitioners Australia Pty Limited (STEP Australia) represent professionals from across Australia who are specialists in trusts, estate planning and in supporting the needs of families (young and old, wealthy and modest). The objective of a STEP Professional is to advance the interests of families across generations. This often involves us in identifying issues of relative importance to families and bringing these to the attention of those who can make a positive difference. This is the purpose of this submission.

STEP Australia's membership includes lawyers, accountants, financial wealth advisors and trustee company professionals from across Australia; our members bring a multi-disciplinary approach to the benefit of their clients. It is this unique multi-disciplinary approach that supports this submission.

Recommendation

We urge the removal of the 'requirement' for the bare trust arrangement in section 67A of the Superannuation Industry (Supervision) Act 1993 (Cth) (SIS Act) with respect to limited recourse borrowing arrangements.

Principal among the reasons for this suggestion is the perspective that this 'requirement' creates complexity, increases costs and administration and yet achieves no practical or real benefit to the superannuation fund, its members or the superannuation and retirement objectives of Government. Indeed, removal of this 'requirement' and the resultant cost and administrative savings will enhance achievement of the Government objective and recognition

of Australian superannuation as the important second and third pillar of the Australian Retirement Income System[1].

Background

If a superannuation fund borrows to buy something, section 67A of the SIS Act imposes the requirement that the investment must be held by a separate entity as trustee for the superannuation fund. Economically and practically this serves no purpose and results in extra costs and complications. The apparent belief is that the existence of the section 67A compliant trustee creates a greater protection for all other assets and interests of the borrowing superannuation fund. For the reasons expressed below this is not correct.

The most common form of section 67A compliant trust is a bare or absolute entitlement trust. It is sometimes also known as a security or holding trust. For this submission it will be called a bare trust since this is the most common form that is adopted.

SIS section 67A can be modified to remove the bare trust requirement in a manner that maintains current arrangements and allows borrowings with or without the bare trust format, in whatever form the parties adopt. A simple amendment suggestion is attached with the suggestions highlighted. This suggested change will amend the law to allow for a superannuation borrowing with or without the bare trust arrangement. This accommodates all types of superannuation funds, no matter whether these are large or small, whether regulated by the Australian Taxation Office[2] or the Australian Prudential Regulatory Authority[3] .

Some argue that … *The trust requirement avoids the creation of charges over the other assets of the fund, which would put those assets at risk.* This is not true, the trust does not achieve this, the requirement under the LRBA law that the loan is limited in recourse to the asset is what achieves this. Again, the bare trust plays no practical protection role, it generates no economic or legal benefit. The trust merely adds cost and complexity to an otherwise relatively simple concept.

The most common approach to an LRBA that is currently adopted by virtually all lenders and commercial parties and professionals involved is expressed in the attached diagram of a Typical LRBA Structure.

Hopefully the diagram and the steps outlined in it make clear that it is not the bare trust that *avoids the creation of charges over the other assets of the fund*. This is the fundamental purpose of the bare trust and bare trustee but the purpose is not achieved by the trust relationship. It is the legal requirement that the superannuation trustee loan and therefore the entitlement of any lender to the superannuation fund to financial recourse to any assets of the fund, is limited in recourse to the asset in respect of which the borrowing was applied.

The most common current LRBA approach establishes the curious outcome whereby the borrower superannuation fund trustee does not have title to the asset in respect of which it did the borrowing, but the borrower has title of all of the other assets that are not allowed to be used as security for its borrowing.

1 As recognised in the Australia's future tax system, The retirement income system: Report on strategic issues May 2009

2 With respect to self-managed superannuation funds.

3 With respect Industry Funds, Employer Sponsored Funds and For-profit Funds.

The relevant legal principal derives from the Privy Council decision in Hardoon v Belilios[4]. In that case the Privy Council concluded that where there is only one beneficiary of the trust (such as the super fund) and that beneficiary is of full capacity, that beneficiary is subject to an equitable personal obligation to indemnify the trustee to the fullest extent. *This is no new principle, but is as old as trusts themselves*[5].

This most fundamental of legal principles applies to the most common LRBA arrangement where the holder of the property (the bare trustee) holds the property solely for the superannuation fund. The fact is that the law causes the general assets of the super fund to be exposed to any liabilities incurred by the bare trustee, it is the terms of the LRBA which provides for the limitation of liability, not the bare trustee arrangement.

Removing the bare trust requirement will not result in any greater or lesser risk to the assets of a superannuation fund.

Costs and Benefits

The suggested amendment is prospective and allows a continuation of the current arrangements *and* the adoption of new arrangements without a bare trust. Current financial products and arrangements are not affected. Consequently the cost to industry will be negligible, indeed it is expected that there will be cost savings to all parties that are involved in any LRBA arrangement.

The current bare trust arrangement, creates several unnecessary risks regarding capital gains tax[6], GST and stamp duty. Also there are extra costs of acquiring and maintaining the bare trust. There are many other concerns associated with Bare Trusts which were identified by the Board of Taxation[7]. The issues surrounding beneficiary liabilities for trustees have also been considered on several occasions by various State Law Reform Commissions[8]

This amendment submission eliminates the future risk of these liabilities and the need to amend other laws, which has been mooted and may prove politically impossible in respect of the numerous state/territory stamp duty regimes.

There will be substantial cost savings for all types of superannuation funds, which would otherwise erode retirement savings, such as:

- Establishment of a corporate holding trustee = $800
- Creation of Holding Trust and other associated legal documents = $2000
- Legal advice in relation to the above = $1500
- Additional banking fees and interest charges = $2,000
- ASIC fees of a corporate holding trustee = $263 (annual)

[4] Hardoon v Belilios [1901] AC 118.
[5] Hardoon v Belilios [1901] AC 118, 123–124
[6] Division 235 of the Income Tax Assessment Act 1997 was enacted to specifically address perceived taxation concerns with the LRBA arrangements. Refer in particular section 235-840.
[7] Self-initiated Review of the Tax Treatment of Bare Trusts and Similar Arrangements, June 2017.
[8] Such as within Consultation Paper 19, New South Wales Law Reform Commission, October 2017.

- Audit = $400 (annual)
- Accounting = $500 (annual)
- Liquidation of corporate holding trustee = $1500
- Creation of legal documents to unwind the structure = $1000
- Stamp duty and other registration costs in unwinding the structure = $1,000

All of these costs are incurred today over the life of the borrowing arrangement. These costs are unnecessary and achieve no real benefit to the superannuation arrangement. The bare trust is not essential to the outcome of limiting the loan to the asset that was purchased with it.

The vast majority of those who embark on super borrowing do so with no understanding of why the bare trust must be adopted. Removing the need for this will enhance understanding and improve confidence in the superannuation system.

Removal of this 'requirement' will allow the borrower superannuation fund trustee to hold the legal title to the asset that was the subject of the borrowing. The same mortgage security will be in place in favour of the lender and this will be limited to the relevant assets and not be enforceable against any other assets or interests of the superannuation fund trustee.

An Historical Perspective

It is a basic tenet in trust law that a trustee may not borrow; that is unless the trust deed of the trust empowers the trustee to do so. Prior to the introduction of section 67A (and its predecessor) SIS reflected this by specifically prohibiting a trustee from borrowing except in very limited operational circumstances.

The superannuation industry developed various ways to 'get around' this prohibition, among the first of these was to have the super fund invest in a unit trust that did the borrowing. In this way gearing was achieved but not directly by the super fund trustee. This strategy was closed in 1999.

The structured finance market responded to the continuing demand for borrowing within superannuation by creating bundled investment products that enjoyed internal gearing or borrowings. A feature common to these structured finance products, which became known as instalment warrants, was the existence of the bare trust.

In the early 2000's the Australian Taxation Office and the Australian Prudential Regulatory Authority both issued statements that expressed the view that instalment warrants breached the superannuation borrowing prohibition. This fired up the structured finance market whose efforts in lobbying were rewarded with the 2007 amendment to the SIS that allowed superannuation borrowings, providing the expressed format was followed.

The approach of (and presumably the brief to) the parliamentary draftsman was to incorporate the need for a bare trust so as to most closely align the new borrowing capacity with the then instalment warrant practice. In time it became apparent to lenders that the bundled approach to lending via the instalment warrant could be unbundled, but the legislation required the bare trust to nevertheless be part of an unbundled borrowing structure.

With twelve years of history behind the unbundled borrowing arrangement it is now time to remove the need for the bare trust.

Is there a use or benefit with requiring the bare trust to be part of a borrowing arrangement? No, there is no benefit where an unbundled approach to borrowing is undertaken.

The true original purpose of the bare trust arrangement was to enable the lender to take security over the asset acquired with the debt by holding the asset in a bare trust structure that it controlled. This is no longer necessary. Though for those who wish to maintain this practice, the suggested amendment allows this. The suggested amendment only removes the requirement for the bare trust, this can still be used by a lender or structured finance product provider.

Removing the need for the bare trustee does not diminish protection of superannuation, in fact it enhances this.

Conclusion

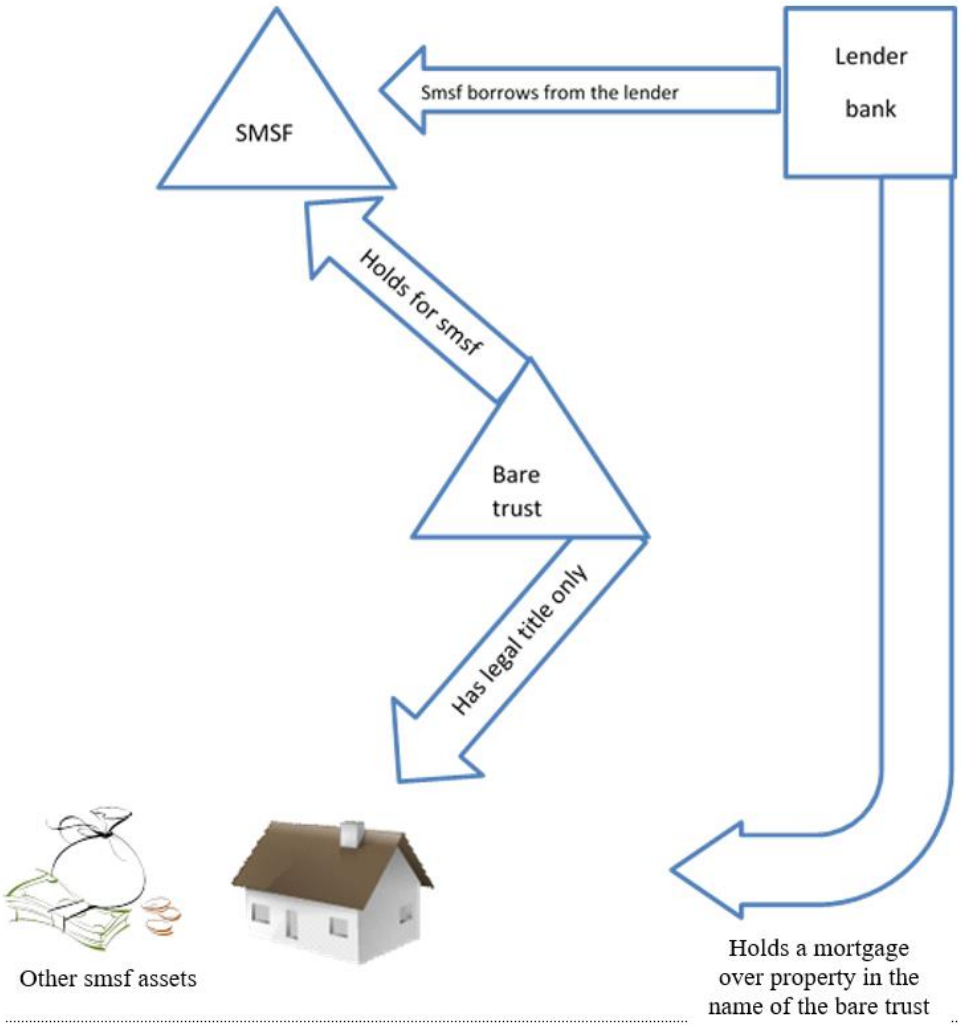
By the adoption of 11 words simplicity and cost savings will be achieved, without a reduction of the core underlying principles or security of superannuation generally.

If you would like to discuss any of the above, please contact Peter Bobbin TEP, STEP Australia Chair on +61 2 9895 9370.

Yours sincerely

Peter Bobbin
Chair of STEP Australia

Typical LRBA Structure



1. The superannuation fund seeks a borrowing. Approval for the borrowing is given to the trustee of the superannuation fund.
2. The superannuation trustee arranges for another entity (commonly an associated company) to be the bare trustee. This will hold the property.
3. The superannuation trustee enters into a loan agreement with the lender. That is, the formal borrower is the superannuation trustee.
4. A contract for purchase is entered into by the bare trustee. The deposit is paid direct by the superannuation trustee from superannuation fund monies.
5. On settlement of the contract for purchase,
   (a) the lender pays the borrowed monies (under direction by the superannuation trustee) to the vendor of the property. Notably, the borrower of the monies is the superannuation trustee. It is the same entity that holds all of the superannuation wealth and assets.
   (b) the property is conveyed into the name of the bare trustee.
   (c) the bare trustee grants a mortgage over the property to the lender,
   (d) the mortgage being security for the loan by the superannuation trustee.

Suggested Amendment to Section 67A of the SIS Act

(Yellow highlights are the suggested additional words)

Superannuation Industry (Supervision) Act 1993 - Sect 67a
Limited recourse borrowing arrangements
Exception
(1) Subsection 67(1) does not prohibit a trustee of a regulated superannuation fund (the RSF trustee) 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 a single acquirable asset, including:

(i) expenses incurred in connection with the borrowing or acquisition, or in maintaining or repairing the acquirable asset (but not expenses incurred in improving the acquirable asset); and

Example: Conveyancing fees, stamp duty, brokerage or loan establishment costs.

(ii) money applied to refinance a borrowing (including any accrued interest on a borrowing) to which this subsection applied (including because of section 67B) in relation to the single acquirable asset (and no other acquirable asset); and

(b) the acquirable asset is held BY THE RSF TRUSTEE OR IT IS HELD on trust so that the RSF trustee acquires a beneficial interest in the acquirable asset; and

(c) the RSF trustee HAS LEGAL OR has a right to acquire legal ownership of the acquirable asset by making one or more payments after acquiring the beneficial interest; and

(d) the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) default on:

(i) the borrowing; or

(ii) the sum of the borrowing and charges related to the borrowing;

are limited to rights relating to the acquirable asset; and

Example: Any right of a person to be indemnified by the RSF trustee because of a personal guarantee given by that person in favour of the lender is limited to rights relating to the acquirable asset.

(e) if, under the arrangement, the RSF trustee has a right relating to the acquirable asset (other than a right described in paragraph (c))--the rights of the lender or any other person against the RSF trustee for, in connection with, or as a result of, (whether directly or indirectly) the RSF trustee's exercise of the RSF trustee's right are limited to rights relating to the acquirable asset; and

(f) the acquirable asset is not subject to any charge (including a mortgage, lien or other encumbrance) except as provided for in paragraph (d) or (e).

Meaning of acquirable asset
(2) An asset is an acquirable asset if:

(a) the asset is not money (whether Australian currency or currency of another country); and

(b) neither this Act nor any other law prohibits the RSF trustee from acquiring the asset.

(3) This section and section 67B apply to a collection of assets in the same way as they apply to a single asset, if:

(a) the assets in the collection have the same market value as each other; and

(b) the assets in the collection are identical to each other.

Example: A collection of shares of the same class in a single company.

(4) For the purposes of this section and section 67B, the regulations may provide that, in prescribed circumstances, an acquirable asset ceases to be that particular acquirable asset.
RSF trustee

(5) Paragraphs (1)(d) and (e) do not apply to a right of:

(a) a member of the regulated superannuation fund; or

(b) another trustee of the regulated superannuation fund;

to damages against the RSF trustee for a breach by the RSF trustee of any of the RSF trustee's duties as trustee.

(6) A reference in paragraph (1)(d) or (e) (but not in subsection (5)) to a right of any person against the RSF trustee includes a reference to a right of a person who is the RSF trustee, if the person holds the right in another capacity.