

SMSF BORROWING

RULES OUT OF GEAR

Recent changes to SMSF rules were intended to simplify the borrowing process. Rob Jeremiah and Naomi Pavlakis highlight some areas where reform has fallen short.

At a recent meeting of the National Tax Liaison Group (NTLG) superannuation sub-group the subject of SMSF borrowing was raised as a discussion point. At this meeting, the Small Independent Superannuation Funds Association (SISFA) director Rob Jeremiah identified certain aspects of the legislation he believes are ambiguous. The main points raised are detailed below.

Much is yet to be finalised via Australian Taxation Office (ATO) decision making, but it is worth highlighting some of the key issues facing advisers and service providers confronted with SMSF borrowing rules.

Accessory or multiple titles

Common scenarios:

- A commercial building is purchased and has a number of strata titles for each level;
- An apartment is purchased with an accessory carpark on a separate title. Depending on jurisdiction:
 - The titles to the apartment and accessory carpark title may only be transferred together; or
 - The titles may be dealt with separately.

In Victoria, for example, carpark titles are stapled to the apartment title and cannot be dealt with separately. However, the position

may be different for older titles or in other jurisdictions.

SISFA issues

SISFA queried whether the ATO regarded the above scenarios as involving one or multiple assets.

From a practical perspective, greater certainty would be achieved if general guidelines were developed so that SMSFs are not required to seek advice from the ATO on a case-by-case basis.

Implications:

If the above scenarios are considered to involve multiple assets for the purposes of section 67A, this has the following consequences:

- Separate borrowings and separate loan documents are required;
- Separate bare trust deeds (that is declaring a trust over each "single acquirable asset") are required;
- If the SMSF defaults on a particular loan, the lender's security will be limited to the particular title. The lender's security will not extend to an interest in the land comprised in the other title(s). Practically, this means:
 - The legal fees involved in documenting the SMSF borrowing will increase significantly;
 - The ongoing accounting and audit fees incurred by the SMSF as a result of having to maintain two or more separate borrowings could also increase;
 - Lenders might charge additional fees for the establishment and maintenance of multiple loans;
 - Lenders might be reluctant to lend at all if they cannot effectively take security over what for all practical purposes is a single asset but is comprised in more than one title.

It is submitted that interpreting the above

scenarios as involving multiple assets produces an unfair and unintended result. For example, if the titles to a property were consolidated into one title by the vendor, the SMSF would be able to borrow to buy the same property without giving rise to any of the above complications. This supports the view that an asset for the purposes of the *Superannuation Industry (Supervision) Act 1993 (SIS Act)* is not meant to be defined by its technical legal title.

From an accounting point of view, the above scenarios would be classified as involving one asset (for example, in the balance sheet of the SMSF). SISFA has submitted to the ATO that accounting principles and concepts be applied in determining the meaning of asset for the purposes of the *SIS Act*.

Improvements/"Single acquirable asset"

Common scenario:

- An SMSF trustee borrows to buy land and uses its own non-borrowed money to improve the structure on the land.

SISFA issues

Clarification is being sought from the ATO regarding its view as to whether improving an asset creates a replacement asset.

SISFA notes that improving an asset necessarily implies taking an existing asset and making improvements such that the original asset is then improved. That is, the concept of improving implies that the same asset continues to exist, but in an enhanced state.

If an improvement is regarded as creating a replacement asset, this suggests that the original asset comes to an end and a new asset begins to exist. In SISFA's opinion, such an interpretation is inconsistent with the concept of improvement.

Implications:

- If the ATO regards improvement to an asset as giving rise to creation of a replacement asset (and hence a new asset), further questions arise:
 - When does an improved asset become a replacement asset such that it does not retain its original character and can



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no longer be said to be the “single acquirable asset” acquired at the time of the borrowing?

- If improvements are gradually made (for example, over two years as construction takes place), at what point in time is the new asset created, leading to the borrowing failing to meet the requirements of section 67A?
- Alternatively, assume that farm land is acquired via a borrowing arrangement. Fences and sheds are established, a crop is grown on the land and pipes are placed in the ground. Are the pipes, fences, and sheds improvements?
- What is the difference between a repair and an improvement? For example, if a building burns down, would the reconstruction be a repair or an improvement?

Even if an SMSF trustee uses non-borrowed money to rebuild the structure (such as insurance proceeds), if this is seen as an improvement the reconstruction might result in the same land with a new building on it being treated as a new asset, which would cause the SMSF trustee to breach section 67A.

From a property law perspective, the asset that is acquired is the land, including all fixtures/improvements, whether they are the fixtures/improvements at the time of purchase or at some future date.

It is submitted that if vacant land is acquired by a superannuation fund with borrowed money, the installation of water, sewerage and gas piping and facilities and power facilities on the land would not create a new asset.

Arrangements

Presently there is no certainty as to what an arrangement under the borrowing provisions of the *SIS Act* is. The ATO has not expressed a formal view as to what an arrangement is.

This issue was discussed at the NTLG superannuation sub-group meeting.

SISFA submitted that at law there must be two parties that have a meeting of the minds for an arrangement to exist.

SISFA's submission (referred to in NTLG superannuation technical meeting's minutes of September 2010), stated in part:

“[A]n arrangement has been entered into if there is an understanding between the parties of the key terms of the loan and expectation that these will be formalised into binding loan documents.”

Bare trusts

The ATO's preliminary views on bare trusts were raised at a recent NTLG superannuation sub-group meeting.

Mortgage over the asset:

It is SISFA's view that the fact an asset is mortgaged to a lender by a bare trustee does not preclude the existence of a bare trust relationship.

Consider a non-SMSF context: if an individual borrows to buy a property and the lender takes a mortgage over the property as security, that individual might request that someone else hold the legal title on bare trust for the purchaser. The mortgage will place some restrictions on the purchaser, but the purchaser is still absolutely entitled to the property as against the bare trustee. The bare trustee grants the mortgage to the lender but it does so simply as bare trustee for the purchaser. In doing so the bare trustee does not therefore create any restriction that detracts from its bare trust relationship with the purchaser.

The same applies to a limited recourse SMSF borrowing. SISFA therefore disagrees with the suggestion that the charge (mortgage) granted by the bare trustee over the property means the trust cannot be a bare trust.

Transfer from the bare trustee after the loan is repaid:

It is further submitted that an asset held on bare trust does not give rise to an investment in that trust. The beneficiary has an interest in the asset only.

SISFA disagrees with the suggestion that section 71(1) of the *SIS Act* should be interpreted broadly so that investment in a trust could be taken to include a bare trust arrangement. Investment in a trust involves having an interest in the trust, which does not exist in a bare trust relationship.

Therefore, it is SISFA's view that after the loan is repaid and there is no doubt that the asset is held on bare trust, the bare trustee can continue to hold the asset because there is no investment in a trust and therefore the arrangement does not create an in-house asset

issue under section 71(1) of the *SIS Act*.

ATO Interpretative Decision (ID) 2010/162

SISFA welcomes the ATO's clarification within the ID that the expression “invest” used in section 109 of the *SIS Act* includes entering into a limited recourse borrowing arrangement. However, discussion within the ID regarding arms-length dealings has created some confusion. Clarification is being sought from the ATO regarding SMSF borrowings from related parties that are on terms more favourable to the SMSF than might be expected if the parties were at arms-length.

Section 109(1) (b) provides that the terms and conditions of the transaction must not be more favourable to the other party than would be reasonably expected if the parties were at arms-length. SISFA agrees that an arrangement which is favourable to the SMSF would not breach section 109(1) (b).

However, the ID does not discuss section 109(1A), which provides that an SMSF trustee is required to deal in respect of any investment with another party that is not at arms-length in the same manner as if they were at arms-length.

SISFA understands the ATO agrees that section 109(1A) effectively requires an SMSF trustee to deal with a related-party lender as if they were at arms-length and that this would require the terms of their arrangement to reflect arms-length terms (that is, be no more or no less favourable to the SMSF than an arms-length arrangement). If this is so, in SISFA's view comment to this effect should be added to the ID as based on the ID some commentators and advisers in the superannuation industry have expressed the view that an SMSF that borrows from a related party on term, more favourable to the SMSF than an arms-length arrangement would not breach the act.

As mentioned, most of the issues raised above remain outstanding after the NTLG superannuation sub-group's review. We await ATO clarification. This article sought to outline some of the issues being discussed with government in regard to SMSF borrowing and matters requiring further decision making. ●

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